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Not getting covered for political risk is a management fault

Shareholders and financial operators are more and more concerned about covering the political risk. It is not the case of all the companies investing in countries out of the OEDC. They sometimes suffer from important financial losses.

The Globalization makes us think that the Earth is just a little planet where there is a world economic order. However, each country kepps its sovereignty and political instability is a source if uncertainty for private investors. The new governments are tempted to make different choices than the ones of their predecessors to be recognized, by creating a dominant religion, refuding to deal with former certified intermediaries or launching destructive campaign of extermination of minorities. The current events show a serie of events which financial consequences can be heavy for companies: will of the Zimbabwe President, Robert Mugabe, to expropriate white farmers without any indemnisation, populists announcements of his Venezualian homolog, Hugo Chavez, suspension of the national currency convertibility in Indonesia, refusal of the Chineese central government to help the regional bodies in their financial difficulties, coup d'Etat in the Ivory Coast leading to the abrogation of the Constitution, institution of the chiaria in Nigeria, extermination wars in Kosovo and in Tchetchenia, sanctions towards Austria.

The Chief executive is not responsible for the related damages but they are directly or indirectly caused by the public authority. In risky countries (the whole world apart from the OECD), the political risk arise in various forms:

- Confiscation, expropriation, nationalization, or in more informal ways, difficulty to operate because of persitent public disorder or discriminatory measures (no renewal of permits for mining development, non allocation of export licences to Europe for vegetables producers)
- Destruction of current assets, sabotage of assets during riots, civil war or international conflict.
- Deprivation of the company's dividends and benefits outside the host country caused by a shortage in local currencies, or inconvertibility.

There are also risks for companies getting a contract with the State, when selling equipments or ready to use units dedicated to the management of a public service or an infrastructure, as those contracts are operated on the long term whereas the needs and priorities of an unstable country can change suddenly and quickly. The State can fail to honour his agreements and the contract can be abusively terminated without any indemnisation as it was stipulated.

Who is responsible for this? Bankers usually make provisions when operating in risky countries, as required by the Benking Commission. Those are fiscally deductible. On their side, exporters are used to transfer risks to insurers or bankers as a way to secure their operations and financial results. Finally, importers get usually covered for delivery failures when goods are part of a major contract. However, companies investing in risky countries (banks or industrial firms), as well as those creating subsidiaries don't often feel the need to get covered for those assets in the balance sheet. When deciding to settle in a country out of the OECD, the investor that political risk doesn't exist. Along time, he feels protected thanks to his network and/or know-how. However, around the world, companies which sizes and know-how make them untouchables are extermely rare and even managers of multinational firms can be sequestrated, incarcerated and even murdered.

Statistically speaking, it is true that damages linked to government action are most of the time exceptionnal, which makes investors consider a zero risk. However, financial losses due to political risk and hitting companies in foreign countries, can be huge. Hence, political risk on out-of-OECD investments is a real financial risk, even if note readable as such in the main company balance sheet. One can observe that most companies get insurance after they have benn through a major damage.

For the last couple years, the international market for the insurance in political risk is particularly dynamic. At first, it was limited to the public insurers, but in the eighties, the market openened to private insurers. As a result there are new insurance companies arising on the London market. Private and public insurers work together on this specific risk. They work with the same specialized brokers, which enables them to have a good foolow-up of the customers needs. They also use the same reinsurers, which enables a good harmonisation of the products.
The abundance of products covering political risk on investments refrains companies from using simple implicit autoinsurance. Some products are made to get protected at a reasonable price (from 0,4% to 2% per year of the insured amount, according risks) and on the long term (five years, ten years, fifteen years…); the profit sharing of the parent company being durably consolidated at a tariff known by advance.

The market does exist and work properly: most of the time, indemnisations are important. As an example, in Indonesia, an American company had concluded with the Indonesian government the building of two geothermical energy production units, the national company of electric distribution having to buy the produced energy on two sites. As the public company has finally refused to honor its commitment, the insurers had to repay 290 million dollars indemnities to the American company.

In those circumstances, the analysts don't understand why companies prefer "implicit autoinsurance". The level of profitability which is usually high in risky countries make the insurance premium painless and the autoinsurance, by its reserves making, is not fiscally significant, as some possible provisions for country risk are not deductible for a non banking company.

When the investor is confident, he would rather not cover his risk. However, it is also the time when the insurer will accept to take his risk burden at a low rate and on the long term. Moreover, the broker inventiveness enables to optimize the set up to reduce the premium without damaging the cover. Then, if the situation deteriorates, the insurer linked by contract to the asssured will still carry the risk at a very good rate.

Some polls among professional analysts are very instructive. Notations agencies, auditors, bankers, portefolio managers and shareholders are more and more interested in the foreign investment protection policy carried out by companies.

At the time being, the traditionnal auditors, during annual audits, don't seem to be concerned when a company isn't covered for its foreign investments in emerging risky countries. However, during exceptional operations (acquisition audit, stock exchange introduction), the non protected assets are made below par rating. The value of the company is reduced of the same amount.

A small domestic company can choose to assume those risks, if it doesn't use external financing (from the Bank or the Stock Exchange), but when it deals with a company from the Stock Exchange Marke, it has to be extremely careful. This implicit autoinsurance practice is particularly dangerous for industrial firms, which property has a significant renewal value, as financial losses coming from thos risks can be high. The European analysts are now doing the same than the British Notation Agencies to punish the absence of risk management and the non protection of sensitive assets.

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