The Political Risk Insurance Market and the Current Crisis

by **Charles Berry**

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Is there any financial market currently not in turmoil?

Yes. There is one at least that is functioning properly, and that is the property/casualty insurance market. In particular, the specialist insurance market for large and complex risks, of which the Political Risk Insurance market forms a small part, is in good health.

It was not always so. The long term liability crisis and the overheated excess of loss reinsurance market in London in the early 1990s (the LMX spiral, as it came to be known) nearly toppled Lloyd's, a lynchpin of the specialist insurance market centred in London. Though Lloyd's problems of the time were only a little local difficulty compared to the current credit crunch, I am not the first to compare the LMX spiral to the current banking crisis.

The comparison starts with the excess of loss reinsurance market's layering or tranching of risk, with the original insurer retaining the first loss, and passing the higher, less risky tranches to others. Having built up a sound track record of profitability, the LMX market attracted too much capital in the late 1980s and overheated. As a result trading became more important than origination for many Lloyd's syndicates: the structure of their reinsurance program became more important than the quality of the risks they wrote; and loss of underwriting discipline at the origination end of the business caused the market to take on portfolios of toxic, under-priced risk. The Piper Alpha disaster in the North Sea was only the first of the major losses that exposed the damage that the LMX spiral had wrought. A USD 1 billion loss to the policyholders translated into USD 40 billion of paid claims within the London market as the loss ricocheted around the spiral. The losers in this game of pass the parcel were the Lloyd's syndicates that ran out of reinsurance first.

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The over exuberant LMX spiral (which had appeared to have introduced a new market paradigm) only served to remind the London insurance market of some fundamental truths: namely, that an overheated secondary trading market produces a mentality that undermines origination discipline; and that no amount of trading can rid a financial system of the toxic assets that are introduced into the market as a result. Sub-prime holds the same message for the banking market.

The Lloyd's crisis was eventually worked through, at a huge cost to many of Lloyd's backers (about 4,000 personal bankruptcies), the passage of time, and a degree of mutualisation around the market (but without tax payers money). However it is precisely because Lloyd's and the London insurance market recently had this near death experience that the market's fundamentals are today arguably stronger than they have been in living memory. This is illustrated by Lloyd's recent results. 2008 was the third worst year on record for catastrophe insurance losses, but Lloyd's posted a profit of £1.9 billion, on a combined ratio of 91.3%.

The insurance market still has its problems of course: the insurance industry cycle is not dead; the market has had to weather major losses from 9/11, Katrina, and then Ike and a run of other catastrophes in 2008. Now the market faces significant (but manageable) losses under liability policies in the wake of the credit crisis, an event that will also impact to some extent the assets side of the insurers' balance sheets (though illustrating the conservative bent in insurers investment strategies, Lloyd's made a positive investment return in 2008). So will today's property/casualty insurance market require a systematic government bail out? Absolutely not.

But what about AIG? In reality, AIG perfectly reflects the current contrast between the insurance and banking industry: in the last 15 years the insurance industry has stabilised around fundamental principles, such as underwriting for profit through the cycle and improved risk management; in contrast the banking industry has abandoned sound lending, and embraced a culture that believed that there is no such thing as a bad loan so long as you could trade it away. If only AIG had stayed with its well-managed and exceptionally strong property/casualty insurance businesses and not wandered far, far too deep into the casino of collateralized debt obligations and credit default swaps, it would not be in its current, truly historic mess. The sooner AIG's sound property/casualty insurance businesses are surgically removed from the smoking wreckage of the group and re-branded, the happier we shall be.

The PRI market accounts for maybe only 1 or 2 percent of the activity of this specialist property/casualty insurance market. The credit crisis and the global slowdown brings us both challenges and opportunities in equal measure. The picture is slightly different within the PRI market's two main categories of cover: emerging market non-payment insurance covering default by both government and, to an increasing extent these days, private obligors; and the "pure" political risks activities that cover assets and investments in emerging markets against expropriation, political violence and similar risks.

On the non-payment side, the PRI market has followed a generally cautious and selective approach to underwriting emerging market credit risk. Even so, the current crisis will provide the market with a major test. We are already seeing a marked increase in the number of workouts, potential claims and actual claims in the market.

However, I am confident that the PRI market will emerge from this crisis with a validated non-payment insurance product, and a validated underwriting approach for emerging market credit risks. Hec-

(Continued on page 3)

The Political Risk Insurance Market and the Current Crisis (cont'd.)

tor Sants, CEO of the UK's Financial Services Authority (FSA) recently commented that bankers need to revert to traditional virtues, like understanding their customers' businesses and assessing risk in the expectation that they will hold loans to maturity. Had he mentioned that they should focus their lending on supporting trade transactions in the real economy, he would have mentioned all three of the fundamental principles that, on the whole, have guided the PRI market's selective approach to underwriting emerging market credit risk. I expect this approach will ultimately stand the PRI market in good stead.

Meanwhile for those insurers who have kept some of their powder dry, the current challenging environment presents interesting opportunities. Even in a major downturn, significant quantities of commodities and goods continue to flow around the world. We expect the non-payment insurance product mix to change, but we expect that the PRI market will continue to play a significant role in supporting trade finance and trade and commodity flows into and out of emerging markets.

Turning to the "pure" political risk coverage of expropriation, political violence and the like, we believe that the current crisis has significantly increased demand for these products.

The events of September and October 2008 have jolted the business community into a more realistic assessment of the political risks present in emerging markets.

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In the 1990s businesses adopted a benign view of the world. The collapse of the Berlin Wall seemed to promise a new era of peace and stability and a new world order based on the rule of law. The spread of democracy and free market principles around the world would surely usher in a new era of globalisation. In a memorable phrase, it was the end of History. The West had won: why buy PRI?

It has been abundantly clear for some time to PRI market professionals that this vision of the 1990s was not being realised. The increased economic and political power of the BRIC countries; global terrorism; resource nationalism; global warming; and now the economic crisis: all point to a new era of instability and disorder in emerging markets. Indeed we may well now have more history in front of us than behind us. Yet it has taken, in our view, the shocks of the autumn of 2008 to remove the rose tinted spectacles through which corporations and financial institutions have been viewing the risks associated with their assets, investments and loans in emerging markets.

This new realism is causing many of our clients to look again at what the PRI market has to offer. They are seeing a product offering very different from that of ten or even five years ago. For the PRI market has been through a significant phase of product development in the last few years. We have in effect reinvented the market for "war risks" on land; in addition we have re-engineered the more traditional investment insurance coverage.

In the property insurance market "war risks" encompasses all political risk perils, starting these days with terrorism, and moving through riot and civil commotion, to insurrection and rebellion, to war and civil war, and including also confiscation. Indeed confiscation, capture and seizure are arguably the main "war risk" perils from a historical point of view. So the " war risk" policies now available from the PRI market for land-based assets provide indemnity for loss or damage to tangible property, and resulting business interruption, due to a wide spectrum of political violence and political risk perils. PRI in a property insurance form, in other words, rather than an equity or lenders form.

The re-emergence of this type of cover for land based property builds on the long "war risks" insurance traditions of the London insurance market, but puts to an end the long period since the mid-1930s when these types of war risk covers were only available for ships and aircraft. It is a far simpler approach to political risk coverage than the traditional, more sophisticated, investment insurance type products. But this simplicity is part of the attraction. Furthermore, we have a very clear message for the risk management community: this type of "war risks" insurance from the PRI market is the only source of political violence coverage that adequately addresses the spectrum of political violence that is commonplace in emerging markets today. This element of the PRI market's product portfolio is therefore essential – not optional – cover for tangible property in emerging markets. And the importance of carrying this type of broad form political violence cover will increase: as the economic crisis bites in emerging markets, political violence of all types will escalate.

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For those who still want to embrace the broader, more complex equity and lenders' forms of investment insurance, they will find that the market offers today a re-engineered product, that goes well beyond the "Expropriation" centred policy, that was standard fare until a few years ago.

While expropriation remains an important element of the risk, today's policies are more roundly focused on an investor's rights. Where clients of the market have perhaps found the expropriation cover wanting in the past, a common thread is that while expropriation may well be a breach of an investor's rights, a breach of their

(Continued on page 4)

The Political Risk Insurance Market and the Current Crisis (cont'd.)

rights is not necessarily an expropriation.

This new focus on the broader rights of an investor has benefited from a changing legal framework for FDI. Though far from complete, the improved network of bilateral and multilateral investment treaties (BITs and MITs) provides a better backdrop for investment insurers to go beyond expropriation cover and address the other rights that investors enjoy in emerging markets. Additionally, the market has become keenly aware that investment insurance claims these days may well take place against a backdrop of international arbitration between investor and host government. It has become necessary to integrate this improved legal environment with the operation of investment insurance policies. In particular, it has become important for policies to address the question of when international arbitration between investor and host government should be seen as a recovery mechanism for insurers after claims payment, and when it should be seen as a necessary pre-requisite for the policyholder to establish that they have a valid claim.

With an improved, broader and better crafted product offering, and with a fresh interest in political risk insurance from clients engaged in emerging markets, we see the current crisis providing considerable opportunities for growth in our activities in the pure political risk area. More generally, while the PRI market certainly has challenges arising from the current crisis, particularly in its book of emerging market credit risks, the market will weather the storm. Like the general insurance market for specialist property / casualty risks of which it forms a small part, the fundamentals of the PRI market are sound, the market is functioning properly, and the market continues to innovate in response to changing client demand in a more challenging global environment. ■