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political risk insurance newsletter

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Inside this Issue

Mitigating Bank Lender Risk

Over time the political risk insurance market has offered increasingly comprehensive coverage for bank loans. We invited Jack Barnes, a Senior Consultant at Willis Limited with thirty years experience in financial risk insurance and reinsurance broking, and David Neckar, Practice Leader for Willis FINE Political and Trade Credit Risk Business with more than twenty-five years specialist financial risk experience in broking and underwriting, to describe this evolution and the current state of the market.

The Evolution of Bank Loan Coverage

Banks have been using private market political risk insurance (as an alternative or complement to state-backed export credit agency schemes) since the early 1980s. At that time the private insurers had recently started to offer public buyer non-payment under the generic of "contract frustration" directly to exporters and traders. Unfortunately, in the few instances in the early days where banks were the insureds, there were some substantial claims. Insurers turned against "bank insureds" so, for the most part, the banks had to content themselves with an indirect position of assignee to the proceeds of the policy ("Loss Payee") for many years thereafter.

However, following the breakthrough into longer period covers in the late '90s, the insurers began to offer expropriation-based coverages to banks for loans to borrowers in emerging markets under policies that were known as "Lenders Form." After the Argentina crisis in 2002, banks moved to buying "Comprehensive Non-Payment" cover, which has now become the norm.

The Impact of the Last Argentina Crisis

The difficulties that some banks encountered over claims in Argentina were partly caused by a failure to appreciate that Lenders Form cover required a loss to be clearly caused by the combination of (a) loan default and (b) expropriation of the borrower or - sometimes - (c) inconvertibility. Crucially, loan default caused by economic difficulties, local currency devaluation, and borrower insolvency was normally excluded in these policies. The dividing line over whether pesification was tantamount to expropriation was arguable - and therefore did lead to arguments. It is important to note that many claims were ultimately paid on these policies but, for a while, the banks withdrew some of their business from the market, and a number of Lenders Form policies were cancelled.

The banks that had purchased Comprehensive Non-payment coverage in Argentina collected their claims without problems: the coverage was simpler since it only required the loss to be caused by the failure of the borrower to pay in accordance with the loan agreement. It was no surprise, then, that the lesson learned by the banks was only to buy Non-payment cover, even though it was more

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The Berne Union: Coming to Grips with PRI Issues

We invited Daniel Riordan, Managing Director of Zurich Emerging Markets Solutions, and current Chairman of the Berne Union's Investment Insurance Committee, to discuss issues and opportunities confronting the Berne Union's membership engaged in PRI business.

The Berne Union is the leading international organization of public and private sector providers of export credit and investment insurance. Founded in 1934 as an international non-profit organization with the aim to facilitate world-wide cross-border trade, it supports international acceptance of sound principles in export credit and foreign investment insurance and provides a forum for professional exchanges among its 50 public and private sector member companies.

Berne Union members provide a vital link in the chain of world trade by offering insurance or guarantees to protect exporting companies, investors and financial institutions against political and/or commercial risks. In 2005, they covered more than US$1,000 billion worth of business, about 10% of the world's total export trade.

Annual meetings of the Berne Union's entire membership

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Political Risk Reinsurance: An Active Partnership

A full understanding of the political risk insurance market requires an understanding of the reinsurance that underpins it. For an explanation, we turned to Ben Love, Vice President of The Benfield Group, a global reinsurance intermediary and leader in reinsurance solutions for insurers of credit and political risks worldwide.

As much as a third of political risk insurance premium and exposure is assumed by the reinsurance market, making reinsurers a significant partner if not always a silent one. Though the interests and motivations of the two are largely consistent, reinsurers can at times curb the strategies of the direct writer, impacting the insurance product made available to customers. In recent years this has affected basic parameters such as ***tenor*** (policy duration) - notably for Lloyd's, which is generally restricted to competing on transactions below thirty six months; ***coverage*** - reinsurer preference for 'trade-related' business and limited, defined perils; and ***capacity*** - per risk or otherwise - for example, in respect of regulations under which certain reinsurers 'pass on' their inability to cover US embargoed territories.

Prudent Risk Management

Despite the potential for such restrictions, reinsurance does play a significant and often critical role in insurer business strategy. In most instances, the ultimate level of political risk losses has been relatively low in volume and magnitude. As a result, historical experience is often not the principal driver for buying external capacity; rather, it is a function of corporate governance and prudent risk management. The nature of the class is such that significant exposures, concentrated in a limited number of countries and often representing multi-year commitments, steadily combine to represent a potentially catastrophic level of loss – <u>*if*</u> business assumptions and practiced techniques for risk selection and mitigation fail.

> "Political risk insurers with an established track record and strong reputation have not been significantly challenged in achieving their desired reinsurance."

Capacity, With Limitations

Reinsurance is the traditional way by which an insurer achieves external support and protects itself against the unforeseen. For buyers of political risk reinsurance, there are two dominant structure types:

1. <u>Excess of Loss</u> – per risk 'XOL' provides a fixed limit per risk above a fixed retention for a fixed premium. Limited reinstatements (i.e. coverage for a second, possibly third loss) are generally provided, at a predetermined price.

2. <u>Quota Share</u> – under a 'QS' arrangement, reinsurers share proportionately in every risk for a proportionate share of premium, less a ceding commission to cover insurer expenses.

Both have limitations for writers of political risk. Per risk XOL does not provide significant protection against 'country loss', i.e. the true catastrophic loss, being a series of losses in one country, and XOL has not generally been available in respect of policies with a period beyond 36 months. QS addresses both these limitations, but at a cost, being both the volume of premium and profit potential assumed by reinsurers, and the level at which it is ceded, being from the 'ground-up', as a fixed percentage of every premium dollar is passed on.

Capacity Developments

Whilst these basic structures have remained largely the same, far greater change has been seen in the volume of reinsurance capacity available to insurers. A significant milestone in the expansion of capacity was the privatization of the short term book of the UK's Export Credit Guarantee Department in 1992 - the subsequent private market reinsurance placement being the first time many reinsurers provided cover for political risks, albeit as an adjunct to their core export credit business.

Throughout the 1990's, the increasing confidence in and understanding of political risk among both insurers and reinsurers supported the formation of several significant direct writers in Lloyd's and company market. Similarly, the growth in full/partial privatizations of public entities, resulting in a quasi commercial/political risk, served to encourage the blending of political and commercial credit writers as each expanded its product offering. In a benign marketplace, such trends were (relatively) smoothly embraced by reinsurers.

Towards the end of the 1990's, specific loss activity (notably in Argentina, Cuba, Russia and SE Asia) undoubtedly tempered capacity and renewal terms, though the reinsurance market for these risks remained largely intact until the events of 9/11.

The Perfect Storm

Whilst the tragedy of 9/11 did not result in any political risk losses, a number of factors combined simultaneously to significantly reduce the capacity available to political risk insurers. These included the recognition of reserving inadequacy (notably, relating to US casualty), the fallout from the collapse of ENRON and a far more challenging investment climate which would no longer compensate for poor underwriting results. Writers such as GE Frankona, General & Cologne Re, Gerling Globale Re, RSA and St Paul Re withdrew from the market entirely, some lost credibility as their credit ratings reduced, whilst others elected to reduce or cut back capacity as opportunities to deploy capital for higher and more immediate returns presented in other classes, such as property, terrorism and aviation.

The significant contraction of capacity impacted buyers of political risk reinsurance in terms of increased price, tighter conditions and far greater scrutiny of coverage/defined perils. Together, these challenged the marketability of a product that was suffering already from a general slowdown in trade and investment.

New Opportunities

Since the end of 2001, the arrival of fresh capital, unencumbered by past issues, has served to once again ease buying conditions. Adding to the renewed interest from incumbent reinsurers, new entrants such as Arch, Endurance and Platinum have contributed to the development of available reinsurance capacity.

The significant hurricane activity of 2004 and 2005 clearly presented a major challenge to the wider reinsurance market. However, the speed with which the reinsurance market recapitalized meant anything near sustainable rate/condition hardening has been limited to business exposed to natural perils. Political risk insurers with an established track record and strong reputation have not been significantly challenged in achieving their desired reinsurance. Indeed, just two years on, most renewals at 1 January 2007 were over-placed, meaning supply is outstripping demand.

Notwithstanding potential losses and a complex underwriting environment,

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Shariah-Compliant Trade Credit and PRI: The ICIEC Model

Diana Smallridge, President and CEO of International Financial Consulting Ltd, is a well-known expert on official financial institutions. Her company recently advised The Islamic Corporation for the Insurance of Investment and Export Credit Insurance (ICIEC) on its organizational restructuring to accommodate the rapid growth of its business. We invited her to describe how Shariah-compliant insurance works, as exemplified by ICIEC.

Islamic finance is in the news and is becoming increasingly relevant to the international finance and investment community. Aside from the numerous Islamic finance institutions in the Gulf region and other Muslim countries, some major international banks, such as Citibank and HSBC, offer Islamic finance facilities. Moreover, Standard & Poor's recently announced the launch of Shariah-compliant versions of its widely used global indices, the S&P 500 Shariah, S&P Europe 350 Shariah and S&P Japan 500 Shariah. Similarly, Shariah-compatible trade credit and investment insurance is available through ICIEC.

ICIEC is a multilateral export credit and investment insurance organization whose shares are divided among 35 member countries and the Islamic Development Bank (IDB), which holds a 50% share and of which ICIEC is a subsidiary.

Established in 1994, ICIEC's mandate is to promote exports from, and foreign investment into, its Islamic member countries by providing and encouraging the use of Shariah-compatible export credit and investment insurance as credit and country risk mitigation instruments.

Shariah-Compliant ICIEC Insurance

ICIEC is the only multilateral insurance company in the world that provides export credit insurance, political risk insurance and reinsurance services according to the Islamic Shariah Law. ICIEC provides Export Credit Insurance for exports from one of its member countries, and provides Foreign Investment Insurance for foreign investments flowing into a member country.

The compatibility of ICIEC's insurance with Shariah is reflected in its insured contracts and in the management of its accounts.

Under Islamic Insurance, only contracts that are 'Shariah-compliant' can be insured. In other words, contracts dealing with Shariah-prohibited goods and services such as alcohol or pork are not eligible for insurance services. Insurance for equity investments in such projects is eligible for standard PRI coverages. For financial contracts (such as credit facilities), the insurance may be provided to cover the principal investment, but not interest, since charging interest on credit is considered usury. Instead, ICIEC insures transactions under the Murabaha form of Islamic finance which enables customers to make a purchase without having to take out an interest-bearing loan. The bank buys an item and then sells it to the customer at a profit and on a deferred payment basis.

Shariah law also impacts the way ICIEC manages its accounts. Instead of placing all financial returns and assets under a single pool, as is the practice for most export and political risk insurers, ICIEC places earnings from premiums and fees into a Policyholder's Fund, which is distinct from core institutional assets in the Shareholder's Fund.

Investment Insurance products provided by ICIEC are not unlike those provided by most similar organizations. ICIEC offers three foreign investment insurance policies:

1. An Equity Investment Insurance Policy;
2. A Financing Facility Investment Insurance Policy; and
3. A Loan Guarantees Investment Insurance Policy.

The policies provide long-term insurance cover against the classic country risks for foreign investment flows into member countries, irrespective of their country of origin. Risks covered include war, civil disturbances, foreign exchange convertibility and transfer restrictions, and government interference.

Recently, ICIEC supported General Electric, USA (GE) in their investment in Pakistan by providing Country Risk Insurance.

GE provided power-generating equipment to the Water and Power Development Authority (WAPDA) under a lease arrangement. WAPDA is a semi autonomous body for the development of water and power resources in Pakistan. The equipment would remain in the ownership of GE, and will provide emergency power relief to the WAPDA. At the end of the lease period, GE would take the equipment back from WAPDA, and likely export it to another country.

The investor had requested that the leased equipment be protected against the risk of Expropriation, including their inability to transfer the equipment out of WAPDA premises, and against War and Political Violence. The total value of the equipment insured was about USD 50 million. The risk was shared by ICIEC, OPIC and a syndicate of private insurers.

Strategic Alliances

ICIEC has partnerships with other major international credit and political risk insurers and multilaterals, including MIGA, COFACE and Atradius. ICIEC recently signed a Memorandum of Understanding with EDC of Canada.

ICIEC, as a regional ECA, also plays a special role with the ECAs of the Organisation for the Islamic Conference (OIC) member countries. In January 2007, ICIEC hosted the 5th Regional ECA meeting in Jeddah, Saudi Arabia, which was attended by ECAs from 17 countries and observers from Africa Trade Insurance Agency (ATI), COFACE, MIGA, Afreximbank, ECGC of India and others. ICIEC has a number of MOUs with these national ECAs and is providing reinsurance.

ICIEC also manages and implements the IDB Group's Investment Promotion Technical Assistance Program in partnership with MIGA and the United Nations Industrial Development Organization (UNIDO). The program promotes improved investment marketing capacity in member countries through technical assistance and the establishment of an Electronic Investment Database on member countries' investment environments and opportunities.

ICIEC plays a key role in promoting investment to the OIC member countries. Through its investment insurance operations, it concurrently promotes investment while ensuring that regional business norms are respected. In order for foreign investors to effectively tap into opportunities in the OIC, expertise in Islamic finance is a necessity. ■

ICIEC: Fast Facts and Figures (2006/2007)

- Shareholders' Funds—USD 139 million
- Insurance business increased by 39%
- New insurance commitments rose by 73% to USD 1,399 million
- New products: Documentary Credit Insurance Policy for banks and a Reinsurance Facility Agreement with member country ECAs

PRI Claims Process Roundtable — Part II

In our previous edition we asked PRI claims managers to address questions about the claims process. For the buyer/broker perspective, we sought the opinions of Charles Berry, Chairman of BPL Global, Maura Garych, Senior Vice President, Political Risk Practice, at Marsh, and Paul Aird, Risk Manager, Projects, at Bechtel Corporation.

Q. In your experience, how well does the claims process work, and what accounts for any difficulties encountered?

Charles Berry: You cannot make sensible generalizations about the claims experience of the PRI market without distinguishing among the different product lines that the market sells. Equity and lenders PRI policies are not the main business of the PRI market; most of our business involves covering government (and today, many private, emerging market) obligors against payment default under comprehensive non-payment policies. My firm has settled over 150 claims of this type for our clients and the PRI market's record on this type of claim has been very good. Most of these claims were paid in full. They were not always paid on time, but there is work being undertaken to improve the timeliness of payment for this type of payment default claim.

However, our claims experience has been less satisfactory when it comes to Equity and Lenders PRI Forms. Having said that, our two largest paid claims, each over USD 70 million, were both Equity PRI claims. Equity Forms, and their many versions, generally perform well in circumstances where there has been an outright taking. However (until recently, anyway), such outright takings have been rare in the last 25 years. Conversely, claims involving regulatory takings or breach of contract can be more difficult to settle.

Turning to the Lenders PRI Policy, my belief is that the key to a better claims experience in this area is a more realistic view among policyholders of what the policy does and does not cover. First of all, Lenders Forms cover currency inconvertibility risk well. Here the making of a local currency deposit by the obligor clearly delineates the line between commercial risk and political risk. The problem is that this mechanism of dealing with a foreign currency crisis is out of fashion with host governments.

In other circumstances where an obligor defaults on a payment, it is very often difficult to untangle the political and commercial causes. Where this is the case, policies that cover defaults caused by political perils, but not commercial perils, are going to be difficult to work.

Finally, it would be wrong these days not to also talk about the experience in the market of political violence claims. The experience in this area has been limited, but good so far, despite wording issues on many terrorism policies that still need fixing.

> "You cannot make sensible generalizations about the claims experience of the PRI market without distinguishing among the different product lines that the market sells."
> *- Charles Berry (BPL Global)*

Q. What factors other than the type of claim determine how well the process works?

Maura Garych: In my experience, the size and type of a claim will impact how "easy" an underwriter may be to work with to reach a conclusion. The less objective the cause of loss and the larger the size, the more difficult the process will be. I would rate a Political Violence loss to be the most objective, followed by Currency Inconvertibility, and the least objective are the "Expropriation" type losses. A large, Expropriation type loss will be the most difficult case. Further, if a loss scenario has impacted numerous buyers and insurance policies, the underwriting community will be cautious about setting a precedent with the first claims determination.

From a broker's perspective, the best case scenario is an Insurer who engages both its claim staff and its underwriting staff in the process and looks at a claim as an opportunity to prove the worth of its product. The most difficult Insurer is one with a claims staff lacking in knowledge about the product and other case history, or that begins immediately framing all conversations with concern about admitting any liability under the insurance contract.

Finally, in some instances, the claims process may depend on the overall relationship between the buyer and the Insurer. As in many relationships, open forthcoming communication over time does tend to facilitate the process but less ideal relationships prior to a claim will not likely "help" the claims process.

My experience with claims has highlighted the subjectivity of political risk wordings and the potential for numerous interpretations of language. Language thought to be understood in the market may however be taken quite literally in the analysis of a claim.

> "The most difficult Insurer is one with a claims staff lacking in knowledge about the product and other case history, or that begins immediately framing all conversations with concern about admitting any liability under the insurance contract." *- Maura Garych (Marsh)*

Q. Is the claims process notably different when you are dealing with a public as opposed to a private sector insurer?

Berry: Yes. I say this as I am a firm believer that every claim in the private market is first and foremost a commercial matter that needs a commercial strategy. Likewise, with a government insurer, a claim will take place in a political context for the agency.

Garych: My comments as they relate to the type and size of the claim and how this impacts the claim process apply whether the insurer is private or a public agency. That said, because the public agencies are transparent in their communication of claims submitted and the decisions made, my expectation is that the process is more objective, i.e. collect the facts and weigh the issues to reach a determination. The facts are interpreted knowing they will be subject to public scrutiny.

Q. In a PRI claims situation, do any special problems arise when the insurance is syndicated? If so, how readily are they managed?

Berry: Where a risk is syndicated, there is a greater logistical and administration burden. In the London market, at least, this burden is considerably eased by the established processes and the conventions requiring smaller participants to delegate claims authority.

Commercially, though, there are advantages to syndication. Obviously, if the claim is small and routine it may well be easier to deal with one underwriter. However, if faced with a claim for USD 100 million, we would far prefer to have

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syndicated that risk around the market. It's easier to collect USD 10 million from 10 insurers than USD 100 million from one, however well that one is reinsured.

Garych: Recovery issues should be addressed in the claims cooperation agreement. We are still surprised to find contracts we inherit without completed claims cooperation agreements addressing recoveries, subrogation and communication.

Even with a claims cooperation agreement, syndicated placements increase the complexity because, generally, each underwriter has the right to act only for their own account and therefore all information must be communicated to each Insurer separately (with the exception of Lloyds). In fact, the term "Claims Cooperation Agreement" is a misnomer because it addresses cooperation with respect to recoveries, not the handling or determination of a claim.

"...until liability is accepted, I believe the responsibility for avoiding or minimizing the loss should remain with the policyholder, though this does not preclude the policyholder from seeking the insurer's assistance, if they wish." *- Charles Berry (BPL Global)*

Q. How good are political risk insurers at helping to avoid or minimize a loss, and what role should they play in that process?

Paul Aird: I think public agency insurers have lots of potential but, ironically, for their own political reasons they can't always use the resources they have to avoid or minimize a loss. As an example, if you have a loss developing in Country X but the US government is trying to develop better ties with that country to help fight the war on terror, then US government agencies may be hindered in their ability to negotiate with the country over your claim.

Berry: I think the record of the public agencies in avoiding PRI losses is mixed. I am sure that MIGA and OPIC have rightly claimed successes in this area. However, where the political stakes are high, it seems to me that even the government insurers do not have much clout.

The private market also claims some successes, for example in Argentina, where certain insurers' membership of the Berne Union enabled some transfer losses to be mitigated. This is to be applauded. However, for expropriation and related host government problems, I do not believe that, generally speaking, private insurers bring much to the table, particularly for their larger, more sophisticated clients.

I therefore believe we need to maintain a clear delineation of who is responsible for trying to avoid and minimize the loss at different stages of the claims process. My belief is that this delineation should follow the principle that if the insurers do not know enough about the specifics of the situation in order to accept liability under the policy, then they cannot know enough about the situation to control the risk mitigation and loss avoidance negotiations. Therefore, until liability is accepted, I believe the main responsibility for avoiding or minimizing the loss should remain with the policyholder. This does not preclude the policyholder from seeking the insurer's assistance, if they wish.

Of course, the insurers should still be fully advised and consulted in that process. I fully recognize that the policyholder has a clear duty and interest here, and that the insurers may well have something to contribute.

Garych: We should all be working on the same basis but there seem to be some issues with underwriters' concerns that assisting with risk mitigation may be an admission of liability under the policy. There are documented circumstances where an Insurer has successfully avoided or mitigated a loss (MIGA takes particular pride here). However, there are also cases where an insured simply replies, "act as if uninsured," and it leaves the client in a grey area.

"If you are going to have a useful product, then there should be a meeting of the minds up front about how certain hypothetical claims would be settled." *-Paul Aird (Bechtel Corporation)*

Q. What suggestions do you have for making the PRI claims process work better?

Garych: First, advocate increased transparency and more detailed claims information to be released publicly. If the market had a body of knowledge regarding past claims, Insureds could be educated on the information required to more quickly interpret a claim. Buyers would be educated better up front as to what to expect the policy will cover and will not cover. If underwriters cannot provide specific claims, it would be helpful to have redacted claims histories again to illustrate how the policy works. It would be helpful for Insurers to provide a basic outline of the information they need to see for each type of claim.

Second, expect the policy will be interpreted literally at the time of a claim. Pay close attention to the wording of conditions, warranties and exclusions. Third, consider the potential evolution of a deteriorating situation and err on the side of over-reporting to the Insurer because a marginal situation may in hindsight turn out to be a pivotal point in the "Cause of Loss." Make sure that communication will flow to the parties responsible for reporting under the policy.

Aird: In general there need to be more incentives imposed on the insurers to settle claims more quickly, such as saying they have to pay interest from the date of the loss (and at a rate that is somewhat punitive), and perhaps to pay reasonable costs incurred by the insured to settle a claim. Under the current system, I just don't see much incentive for insurers to actively engage to settle a complicated claim. For a big claim, just the savings on time value of money alone is enough to pay legal fees to drag things out. Also, it would be helpful if there were more information available about claims that have been settled as well as those that were denied, and information about how long it took to settle.

My guess is that if you presented the same hypothetical claim to insurers and insureds, a lot of insurers (and their lawyers) would explain why the loss is not covered, while the insureds would generally think that the hypothetical claim is covered. Of course, lawyers would probably argue that nobody should comment about hypothetical loss scenarios which, in my mind, is wrong as it just delays the dispute until there is a real claim. So something should be done to try and get this on the table earlier. If you are going to have a useful product, then there should be a meeting of the minds up front about how certain hypothetical claims would be settled along with, perhaps, general information about actual claims that were approved as well as those that were denied.

Berry: My advice to buyers of PRI who do not have much experience in claims matters is to use a broker who does. My advice to brokers in our field who do not have much claims experience is not to advertise that to their clients! ■

Mitigating Bank Lender Risk (cont'd.)

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expensive than Lenders Form. The banks' appetite has continued to grow for Comprehensive Non-payment cover, and they are now the largest regular buyers of political risk insurance.

How Non-payment Premiums Are Determined

Premium levels for Non-payment cover tend to move with bank spreads. Currently, as spreads are reducing, so are premium rates. Insurers typically quote a percentage of the bank's lending margin, but most insurers have a "floor" price for a risk, which is arrived at independently of the margin, usually as a function of their exposures (e.g. country, obligor, trade sector). In cases where the "floor" price is above the loan margin, banks have to contribute part of their fee.

The Impact of Basel II

Even before the advent of Basel II, banks had been seeking clearer and less conditional policy forms. As mentioned above, the move to Comprehensive Non-payment post-Argentina was an obvious first step. The next stages were to eliminate, as far as possible, unnecessary verbiage, which was a legacy from old forms. Lloyd's, in particular, has been slow to remove exclusions that other markets had dropped or modified some time ago, but will shortly announce its changes.

Banks that adopt the Advanced Internal Ratings-based approach under Basel II have considerable discretion, it appears, to use conditional credit risk mitigation. However, the issue for the other approaches and in general is not the conditionality itself but whether it relates to actions within the control of the bank. The non-payment product can be made sufficiently clear, and the conditionality sufficiently Insured-specific, to make the policies fit the requirements of Basel II - with only one issue remaining: that of the "nuclear exclusion" (the full title of which is "Institute Radioactive Contamination, Chemical, Biological, Bio-Chemical and Electromagnetic Weapons Exclusion Clause"). Some insurers are willing to remove that exclusion, but, even if it remains in the policies, it appears that many banks are prepared to consider such policies as acceptable. There has been no public comment from regulators or rating agencies.

"Even before the advent of Basel II, banks had been seeking much clearer and less conditional policy forms."

The Future of Insurance/Bank Relationships

Considerable expansion of both demand and supply is likely. The signs are clear at this point: many banks are starting to treat insurance alongside unfunded risk participation, credit default swaps and syndication as an acceptable credit risk mitigant. Insurance actually has the advantages of bespoke fit, confidentiality and not requiring "mark to market." Insurers are showing much greater willingness to adapt their policies. As both sides actively seek to develop closer working relationships with each other, the relationships could develop in a similar way to insurer/reinsurer relationships. But that will require banks to open up their risk-taking processes and make longer-term commitments to insurers - to which insurers in their turn will have to commit themselves. Indeed, this development of reinsurance-type protections could lead banks and brokers to develop stronger relationships with the large reinsurance companies. ■

Political Risk Reinsurance: An Active Partnership (cont'd.)

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interest in political risk continues undiminished, driven even further now by the anticipated ratings weakness in mainstream insurance lines and the tacit encouragement of rating agencies to diversify by product line and geography. The market for buyers of political risk reinsurance is in good shape – with as many as twenty-five reinsurers participating from the US, Bermuda, London and Europe. A further indication of this robustness is the recent re-emergence of political risk facultative (case-by-case) reinsurance – largely unavailable since 2001.

Maximizing the Benefit

If the market for political risk insurance is to really benefit from the greater attention of reinsurers, per the limitations outlined previously, this interest must propel the innovation needed to better address the needs of buyers. To do this, we will have to successfully tackle a number of the idiosyncrasies that distinguish the direct political risk product:

- Policy tenor – the requirement for multiyear coverage is a challenge for much of the reinsurance market, whose focus is 'shorter tail' business and potentially faster reporting of final results and commensurate returns on capital.
- Limited Quantitative Analysis – for most lines of insurance, underwriting and risk are increasingly evaluated using objective, actuarially based techniques. Absent a significant body of relevant loss information, it is not practical to deliver the same analytics for political risk, frustrating reinsurer attempts to analyze the class on a comparable basis.
- Capacity Usage – political risk differs from most insurance classes in that the underwriter can often manage and mitigate exposures before, during and after a claim. The result can either obviate the need for a claim payment or achieve meaningful recoveries. The recognition of this is of central importance to the political risk insurer, though the actual value, as assessed at policy inception, is highly subjective and challenging for reinsurers to correctly reflect in the terms they offer.
- Concentrated Country Exposures - the purchase of political risk insurance is largely discretionary, resulting in an exposure profile for insurers that is concentrated among a limited number of countries. The management of country exposures is a critical factor for reinsurers who must contemplate exposures aggregating across multiple reinsureds. For many reinsurers, limited diversity within the class is a natural brake to their greater involvement.

These factors challenge the emergence of more efficient and effective reinsurance for insurers of political risk. To harness current product interest will require the commitment of participants to step beyond the routine reinsurance renewal discussion and engage in a more protracted period of collaborative discussion. By ensuring a high level of product understanding among reinsurers, through open and interactive dialogue and the provision of good information, structure innovation and greater flexibility is achievable. Assuming, of course, there is no 'perfect storm' which derails. ■

The Berne Union: Coming to Grips with PRI Issues (cont'd.)

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and major committees, and special workshops and seminars are held around the world, providing members with opportunities to exchange views and expertise, address professional challenges and explore opportunities for cooperation. There are three major committees: Short Term (ST), Medium/Long Term (MLT), and Investment (INV) Insurance.

The INV committee promotes the exchange of information among its members who provide political risk insurance for international investors and lenders participating in cross-border investment and lending for emerging market projects. It deals with product and underwriting, risk assessment and premium methodologies, portfolio management, country and sectoral analysis, marketing and distribution techniques, organizational developments, claims and recoveries, and global trends and developing issues. Not surprisingly, nowadays it has a lot on its plate that is of interest to users as well as providers of political risk insurance. Some key issues currently being discussed among members include:

- **Expropriation Risks**: Market conditions are of interest to all members, and views are shared on a variety of different countries and issues. One topic of high interest is rising concern about expropriation risks in Latin America (Venezuela, Bolivia, and Ecuador), Eastern Europe (Russia) and Asia (Thailand). The rise of populist-leaning governments in Latin America, particularly troubling to many infrastructure investors, has led to a spike in interest in political risk products.
- **Establishing Best Practices**: There are efforts within the Berne Union to establish "best practices" for policy and coverage wordings, for example with respect to expropriation coverage. Some members feel that there is a need to provide greater clarity on policy wording and coverage definitions. This is challenging, given that the industry typically offers policies that are heavily manuscripted from template wordings. Coverage for expropriation will be a particular focus in 2007.
- **Political and Commercial Risks**: The expansion of political risk policies to include certain commercial risks is reflected in the significant and growing share of PRI business represented by "Breach of Contract" cover for commercial agreements between private investors and host governments, and "Non-honoring" cover for sovereign, sub-sovereign and municipal entity payment guaranties. Prudent and successful underwriting of these risks calls for expanded professional skills (for evaluating both political and commercial risks) and comprehensive research and financial modeling capabilities.
- **Demand for Broader Coverage and Greater Claims Transparency**: Many INV committee members are reviewing their policies and claims reporting methods to respond to increasing demands from investors and lenders, and their brokers, for broader coverage and greater transparency on claims matters. Some customers and brokers have suggested that traditional coverages and wordings may not adequately address current or potential risk events. They are also asking for detailed claims information on underwriters' handling and reporting of claims matters. In response, many members have opted to utilize their web pages to provide evidence of their responsiveness to claims as well as details on their payment of claims. As an organization, the Berne Union is being asked to provide more transparency on claims and other data in its aggregate statistics. This will continue to be an area of concern and focus for members in 2007.
- **Regulatory Risk**: The risk of new regulations that may deprive investors of their rights is of growing concern to investors and insurers. As regulatory decisions can have dire consequences for some investors, there is growing demand to develop new coverage or to augment existing expropriation coverage to respond to this risk concern. What are the boundaries of this risk, and how does an underwriter provide effective coverage? These are important questions for underwriters considering this new coverage.
- **Collaboration Among Insurers**: Once rare, collaboration via co-insurance and re-insurance is now a common risk management practice among Berne Union members, both public and private, especially with respect to large projects. Most of this activity has involved co-insurance and re-insurance techniques, often with provisions for cooperation in claims matters, but there have also been efforts to swap risks between members to balance each other's portfolios.

These are some of the timely and challenging matters that INV members will confront in 2007. Many of these matters will be discussed and debated with constructive outcomes at the upcoming spring meeting in Ljubljana, Slovenia, the summer Technical Panel meeting in New York, and the fall meeting in New Delhi, India. ■

The Berne Union's **Secretariat** is based in London, and led by Kimberly Wiehl, Secretary General, and Lennart Skarp, Deputy Secretary General.

To lead the Berne Union as a whole, there is a President, a Vice President, and a Management Committee.

The **Management Committee** for 2006/07 is made up by:

President: *Mr Lars Kolte (EKF)*
Vice President: *Mr Angus Armour (EFIC)*
Short Term Committee Chair: *Mr Ladislav Artnik (SEC)*
Medium/Long Term Committee Chair: *Mr Lars Kolte (EKF)*
Investment Committee Chair: *Mr Daniel Riordan (ZURICH)*

People and Organizations

■ **Zurich** reports three new hires: Nurio Gorog, Regional Manager for Europe (Paris); Dennis Eucogco, Underwriter for the Americas region (Washington, DC); and Tim Warren, Underwriter (London).

■ **AIG Global Trade and Political Risk** has hired Rashmi Nehra as an underwriter. She was previously at OPIC.

■ Conal Duffy is Vice President, Emerging Markets at political risk insurance broker **Alliant Insurance Services** in Oakbrook Terrace, Illinois.

■ Daniel Wagner, currently Senior Guarantees & Syndications Specialist with ADB in Manila, will join **GE** to become SVP of Country Risk for its Energy Financial Services division in Stamford, Connecticut.

MARKET PROFILE:

AIG Global Trade & Political Risk Insurance Company

American International Group, Inc. (AIG), world leaders in insurance and financial services, is the leading international insurance organization, with operations in more than 130 countries and jurisdictions. AIG companies serve commercial, institutional and individual customers through the most extensive worldwide property-casualty and life insurance networks of any insurer. In addition, AIG companies are leading providers of retirement services, financial services and asset management around the world.

AIG Global Trade & Political Risk Insurance Co. (AIG Global), a wholly owned subsidiary of AIG, is the company's trade credit and political risk insurance underwriting center of excellence. Its board of directors includes Martin Sullivan, CEO of AIG; Dr. Henry A. Kissinger, former Secretary of State; Richard Holbrooke, former Ambassador to the UN; William Cohen, former Secretary of Defense; Carla A. Hills, former U.S. Trade Representative as well as AIG vice chairmen Amb. Frank Wisner and Jacob Frenkel.

In addition to its headquarters in New York, AIG Global has dedicated underwriters in Chicago, San Francisco, Los Angeles, Toronto, London, Paris, Madrid, Johannesburg, Tokyo, Shanghai, Guangzhou, Shenzhen, Hong Kong, Singapore, Sydney and Melbourne.

Products AIG Global offers the full range of trade credit and political risk insurance coverages. Political Risk policies can be written for tenors of up to 15 years. Policies are issued by AIG insurance companies that are licensed in different jurisdictions. Most AIG companies are rated AA+ by S&P, Aa2 by Moodys and/or A+ by A.M. Best.

Capacity Political Risk policies can be written for tenors of up to 15 years.

Credit Rating Policies are issued by AIG insurance companies that are licensed in different jurisdictions. Most AIG companies are rated AA+ by S&P, Aa2 by Moodys and/or A+ by A.M. Best.

Claims Experience Since operations began in 1978, AIG Global has paid $1.3 billion to settle over 3,700 claims. Nearly $400 million of the paid claims were eventually recovered.

Company Comment With its unquestioned financial strength and worldwide reach, AIG Global has been able to intervene in troubled situations to resolve investment and contractual disputes before they developed into losses.

As a testament to its leadership position, AIG Global was admitted to membership in the Berne Union in 1999. It was the first time since the founding of the Berne Union that a strictly private sector underwriter was admitted.

Key People:
John J. Salinger, *President*
John Hegeman, *Senior Vice President, Political Risk*
Ed Brittenham, *Senior Vice President, Trade Credit*
Tom Ripp, *Senior Vice President, Claims*
Ray Antes, *VP, Political Risk, London*

Contact: aig.com or call 212.770.7000

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about this newsletter

This is the fifth edition of the **robert wray PLLC political risk insurance newsletter**. Our intention is to provide a forum for the exchange of information and opinions relating to topics that will be of interest to political risk insurers, buyers, brokers, attorneys and others. We invite contributions and suggestions from professionals in the field.

We also encourage readers to submit information about notable transactions, personnel changes and other important developments in the political risk insurance sector.

If you would like to receive future editions of the PRI Newsletter electronically, or if you have friends or colleagues who would be interested in joining our distribution list, please e-mail us at *info@robertwraypllc.com*. This and previous editions of the newsletter are available at *www.robertwraypllc.com*

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about robert wray PLLC

robert wray PLLC is a specialized law firm focused on analyzing complex issues and providing innovative solutions in the areas of political risk insurance, project finance, transportation infrastructure, privatization, aircraft finance and microfinance. The firm's political risk insurance practice, led by Robert T. Wray and Felton (Mac) Johnston, offers comprehensive advice related to the mitigation of risks and selection and acquisition of political risk insurance associated with international investments.

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