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Insurance Can Protect Businesses From Geopolitical Risks

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In today's globalized economy, American businesses recognize the value of investing in and trading with developing and emerging markets. International investment enables U.S. companies to access new customers and establish foreign affiliates. In fact, sales by foreign affiliates make up about 40 percent of U.S. multinational corporations' total sales. Worldwide international trade is critical to the U.S. economy. U.S. global exports, in 2016 alone, totaled more than $2.2 trillion. Exports to developing countries constitute more than half of that figure. Developing countries continue to spur most of the world's economic and population growth. Nigeria, for instance, will overtake the United States as the world's third most populous country. These developments mean that U.S. companies will become increasingly reliant on emerging economies.

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For all of the potential upside, investing in and trading with certain emerging economies can carry real risks. Political risk insurance and export credit insurance can help control some of those risks. Political risk insurance insures equity and debt investments against political and related risks. Export credit insurance insures accounts receivable against risk of nonpayment. Both coverages have their limitations. They do not cover all risks inherent in foreign investment and trade, and the policies should be carefully scrutinized with an eye toward potential gaps in coverage. But collectively, they form an important piece of the risk management puzzle that corporations should consider before embarking on business abroad.

Political Risk Insurance

Investing in emerging markets is increasingly commonplace. At the same time, the growing political instability of many developing countries often makes foreign investment seem prohibitively risky. Even in emerging markets that appear relatively stable, political risk has the potential to upend foreign investment and threaten an investment's soundness. Take Thailand, a relatively stable and robust southeast Asian economy, as just one example. In 2015, a year after the country's May 2014 coup, foreign direct investment plummeted 78 percent. As the military junta sends signals that the country remains open for business, confidence is rebounding; foreign direct investment is returning; and the investment risk profile is improving. But the situation remains fragile and unpredictable.

In the insurance context, political risk is the threat that a government decision, civil unrest or other types of political instability will disturb the profitability or viability of an overseas investment. Political risks are beyond the control of the policyholder, and are much less predictable than commercial risks. A business can estimate potential slip-and-fall or product liability claims. Underwriters similarly make decisions that predict the likelihood of significant events, such as hurricanes or earthquakes. However, even the most scrupulous investor typically cannot mitigate, estimate or quantify political risk using due diligence alone. As a result, multinational companies often cannot manage their international investments without political risk insurance.

Political risk insurance can cover a range of risks. We focus here on four main categories: political violence, expropriation, inconvertibility and default.

Political Violence

Political risk insurance shields companies from losses associated with political violence, most commonly damage to tangible assets or business interruption. Although the specific definition may vary, political violence typically means any act carried out for the purpose of overthrowing an existing political regime. The contours of what qualifies as such an act are often disputed. Acts of political violence normally covered include declared or undeclared war, insurrection, rebellion, revolution, civil war, vandalism, sabotage, civil disturbance, strikes, riots and terrorism. Importantly, there may be sublimits that pertain to different types of acts of political violence — another common area for dispute. For example, if ISIS fighters attack a town in southern Turkey, it might not be readily obvious whether the act constitutes an act of terrorism or an act of war, a distinction that may be important for coverage purposes. Classifying different types of cyberattacks may present similar challenges.

In the event of a covered act of political violence, the insured is compensated for the damage to tangible assets and the lost revenue that result. Investors may also purchase political risk insurance to cover evacuation expenses, income losses resulting from temporary suspension of operations of a project, and damage to specific sites outside the insured facility, such as a power station or transportation hub.

Expropriation

A second covered risk is expropriation. Expropriation occurs when a host government confiscates, nationalizes, or otherwise reduces or eliminates a company's ownership or control of a business asset, such as Venezuela's 2011 seizure of the country's gold mining industry, Argentina's 2012 takeover of the country's largest oil and gas firm, and Russia's 2014 nationalization of one of that country's primary oil producers. Additionally, political risk insurance protects against losses resulting from "creeping" expropriation—a series of government acts over time that amount to an unjust seizure of company property. Political risk insurance coverage may be limited to acts of expropriation that are taken or condoned by a foreign governing authority, including a government agency, state-controlled bank, or nationally owned corporation.

Inconvertibility

Political risk insurance also protects against inconvertibility, or an investor's inability to convert local currency into foreign exchange, e.g., U.S. dollars. Conditions of inconvertibility may arise either actively — for example, where a host government effects adverse changes to conversion laws or regulations — or passively — where the government impedes transfer or conversion of funds by failing to act. While political risk insurance provides a backstop when local currency cannot be converted back to the policyholder's national currency, it does not typically protect against macroeconomic risks like currency collapse. The recent decline of the Brazilian real or the Mexican peso arguably constitute currency depreciation, but a decision by either country to block a currency transfer request would constitute currency inconvertibility.

Default

Finally, political risk insurance safeguards investments where a host government defaults on or fails to perform under a loan, contract, or other binding obligation. Claims for default on a loan or contract may require the investor to show that it invoked a dispute resolution mechanism and obtained an award for damages that the host government failed to honor. Typically, however, an investor need not obtain an arbitral award when the host government fails to make a payment under an unconditional financial payment obligation, such as a bond.

Sources of political risk — including government acts, global and regional economic developments, and political unrest — are multifaceted. Thus, unlike other types of insurable risk, political risks are not easily forecast through statistical models. Traditional modeling must be supplemented by qualitative, situation-specific analysis. In addition to defining specific terms under the contract, a political risk insurance agreement typically sets out a formula for the reference exchange rate and a test to calculate the value of damages. Such bespoke policy provisions require careful attention and often extensive negotiation.

Despite being relatively detailed, political risk agreements cannot foresee all possible contingencies, and disputes often arise over the application of a contract to a particular event. Political violence claims, for example, often turn on traditional insurance questions: whether the political event was the proximate cause of the company’s loss, or whether the investor took all reasonable measures to protect and preserve the insured property. In other cases, disagreements can arise over the nature and extent of the investment the contract is intended to cover. In others, insurers may deny coverage for political risks when the policyholder fails to comply with foreign law. To avoid disputes over meritorious claims, careful policyholders often enlist professional advice regarding the drafting and placement of these policies.

Export Credit Insurance

Political risk insurance protects multinational companies against the noncommercial risks of international investment. However, many businesses are also exposed to commercial risks arising from the trade of goods and services to emerging markets. Export credit, also known as trade credit, plays a central role in facilitating trade to developing markets. Businesses commonly offer export credit to their foreign customers as an alternative to prepayment or cash-on-delivery agreements. Export credit allows the customer to pay the policyholder for the product or service using income generated from sales. At the same time, customers in foreign markets often face unforeseen risks that threaten their ability to satisfy their financial obligations. Export credit agreements thus require sellers to assume the risk of nonpayment.

Export credit insurance protects a policyholder’s accounts receivable by insuring against the risk that foreign customers cannot meet their obligations to the policyholder. Export credit insurance covers commercial risks, including insolvency, bankruptcy or protracted default by the in-country buyer. Upon a covered event, export credit insurance assures the policyholder it will be compensated for an agreed percentage of the purchase invoice. Securing export credit insurance reduces the uncertainty of international trade, which allows companies to expand sales to new and emerging markets. Export credit insurance may also permit a policyholder to use its insured accounts receivable as collateral for other investments.

Coverage under an export credit insurance policy may be bounded in important ways. Generally, export credit insurance does not insure physical loss or damage to goods shipped to a buyer, nor does it provide coverage otherwise available through marine, fire, casualty and other forms of insurance. In some instances, export credit insurance only covers situations where the buyer cannot pay, not those where the buyer does not want to pay — a fertile ground for disputes. Finally, export credit insurance does not usually cover situations where the policyholder causes or induces the buyer's nonpayment.

Acquiring Political Risk and Export Credit Coverage

Political risk insurance and export credit insurance policies are available from both private insurance companies and public providers. The public political risk insurance market includes both national and multinational insurers. Many nations sponsor their own investment programs — for example, the U.S. government-sponsored insurer, the Overseas Private Investment Corporation ("OPIC"), helps American businesses invest in countries with emerging markets to promote economic growth of the host nations. Internationally, the Multilateral Investment Guarantee Agency ("MIGA") underwrites political risk coverage to encourage foreign development in member countries.

OPIC and MIGA play a unique role in the political risk insurance market, as both can function as advocates to resolve political disputes as they arise. A policyholder's careful management of a claim can be helped by the diplomatic force of the United States, which backs OPIC. The 181 member nations of MIGA give it claims handling mechanisms that private insurers lack. Both entities may have access to officials at the highest level of host governments, sometimes allowing OPIC and MIGA to help deter state action that would otherwise disrupt valuable investments. Though certain political risks are unpredictable and even inescapable, OPIC and MIGA may help resolve disputes that ultimately would have led to claims.

Export credit insurance policies are available from several state-backed insurance providers. Brazil, China, India and many European countries have government agencies or state-owned enterprises dedicated to providing export credit insurance for domestic goods. The African Trade Insurance Agency, the export credit agency for Africa, provides political risk and export credit insurance to facilitate direct investment and trade flows to its 12 member nations.

In the United States, the Export-Import Bank ("Ex-Im Bank") is the government credit agency tasked with facilitating the export of American goods and services. The Ex-Im Bank is backed by the full faith and credit of the United States, and can provide insurance coverage for risks that the private market cannot or will not accept. Moreover, the Ex-Im Bank is armed with international expertise that can help ease the burden of credit risk management on exporters. The Ex-Im Bank complements a robust private marketplace for export credit insurance.

Conclusion

In Against the Gods: The Remarkable Story of Risk, Peter Bernstein wrote: "The revolutionary idea that defines the boundary between modern times and the past is the mastery of risk." The next chapter of economic development demands that companies manage and mitigate geopolitical risks. Two of those risks — political and nonpayment risks — have the potential to wreak havoc on international trade and investment. But, if carefully navigated, they may lead to major investment opportunities. Both risks are difficult to predict and evaluate. Together political risk and export credit policies remove some of the guesswork, enabling companies to focus on their businesses with increased confidence. Though they do not cover every risk that a corporation will confront in doing business abroad, these policies are two important aspects of a prudent risk management strategy that companies should consider.

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