Challenging exposure

As conflict once again erupts in the Middle East, expropriation begins to rear its head in Latin America, the threat of avian flu remains and oil nudges $80 a barrel – now is certainly a time for those involved in international trade to check their political and credit risk insurance policies. Oliver O'Connell asks key players in the private insurance market for their views on trends, hot spots and the changing demands of their clients.

Anthony Palmer at BPL Global in London

With high liquidity from high commodity price endemic, banks are falling over themselves to lend money at increasingly low prices. The same could be said of the insurance market – but brokers now say that we are reaching a point where the market is bottoming out. Pricing can only go so low before business becomes untenable. Buyers of insurance have been in a strong position for quite some time, but it is possible the bottom has been reached.

Indeed the insurance market and commodity prices are inextricably linked. Inevitably a great deal of raw materials are located in emerging markets, so as commodity prices go up the returns of developing appropriate extraction facilities and related infrastructure, as well as eventually exporting the commodity justify the risk. There are however still high political and credit risks involved and this leads to a high demand for insurance products.

Anthony Palmer, deputy chairman of BPL Global observes: "In the first six months of this year, compared with the same period last year, our enquiry level has gone up by 23%. So there is obviously no problem on the demand side of the business. In terms of the supply side, while the number of underwriters doing our type of business has remained fairly stable, perhaps slightly up on last year, most of them have maintained or increased their capacity. The market is looking pretty healthy."

Fran Watson, trade credit and political risks practice leader at Marsh, notes: "There is definitely a lot of activity in terms of enquiries for trade credit and political risk in general. This is largely coming from North Asia, ASEAN countries and the Middle East and Africa, which is certainly a hot spot at the moment. You would probably include in this the areas of Asia that border the CIS. We are only seeing a limited number of enquiries covering Russia and the CIS. There are also enquiries coming from US corporates who are looking at concentrations of risk and trading patterns across the Atlantic."

In May, Marsh reorganized into three specific regions in May, the Americas, EMEA and Asia Pacific, balancing out the three main risk areas. Watson continues: "The reorganisation has allowed each regional division to have more of a line of sight in terms of targeting different markets and localised risk issues. There are growth opportunities in all three areas, more so at the moment in the Middle East and Africa than anywhere else, but also with financial institutions in South-East Asia and corporate manufacturing is a force in North Asia."

At present Marsh's portfolio sees the Americas division skewed towards political risk business, driven largely by corporates. The financial institutions side of the portfolio is very much driven by the London-based EMEA division, which also includes some financial institution work for Asia. Watson points to Asia as leading the way in terms of growing business and in speed of closure of deals.

Maturing markets?

The present political violence in the Middle East serves as a reminder of the perils of investing in emerging markets – only at the beginning of July Lebanon was still drawing in international investment. Those investors and lenders with insured exposures in the region should review their exposures and coverage, and be in contact with their insurers, as necessary.

While not as volatile as the Middle East, Latin American political risk has been heating up due to the rise of populist leaders in the region. Dan Riordan, executive vice president and managing director of political risk and trade credit at Zurich, observes: "Led by Hugo Chavez, we have seen a rise in left leaning candidates who are increasingly populist in their rhetoric. Evo Morales is the most recent success story in this new populist revolt that is changing the landscape and challenging other left leaning but less populist regimes in the region such as Brazil, Argentina and Chile."

Riordan continues: "While I am not aware of any ➤

Andrew Underwood at Hiscox in London

➤expropriation coverages being triggered in Bolivia or Venezuela, I expect there will be some activity in this area in the future. Investors and lenders would be wise to look at their exposures and check their coverage." (See feature on following pages.)

In addition to the ever-shifting sands of geopolitics, three macro-economic factors have affected the source of business for private insurers: high oil prices have increased trade flows in previously low-key markets; the privatization of formerly state-run industries has opened up further opportunity; and the growth of South-South trade has increased both the intensity and reach of international trade. Trade in these maturing markets still carries risk and therefore a need for insurance.

The high price of oil has lead to a great deal of opportunistic demand for cover in Africa and the Middle East. Countries such as Nigeria are finally getting underway with much needed water, oil and energy projects, funded by oil revenues.

Christina Westholm-Schroder, vice president and chief underwriting officer of Bermuda-based Sovereign, adds: "While there has been a general shift in demand from Latin America into Russia, Turkey, and Eastern Europe. What we've also see growing is demand for cover for countries in Africa which we usually never saw before. This is especially true of countries with oil, which are obviously importing more with their new oil revenue."

Riordan at Zurich concurs: "We see growing demand in the commodities sector, including projects and financings involving oil, gas, and mining. Regionally, we have seen considerable recent growth in Africa, Middle East and Asia."

Privatization of state-run industries also provides opportunities as facilities are upgraded, production is increased and trade flows are diversified. Andrew Underwood, head of political risk, Hiscox Global Markets notes: "The process of privatization in countries such as Ukraine and Russia has also been a source of business. It will be interesting to see where further demand may come from. China is a possibility, and even Iran has announced its intention to privatize non-oil state industries."

Companies in Turkey, Brazil, Russia, India and China, some of which are newly privatized, have now expanded to the point where they are looking to open operations overseas. In many of these countries the support system that you might have in OECD countries from export credit agencies and other government institutions is not yet as developed as it could be, opening up further opportunities for private insurers.

Westholm-Schroder observes: "This is a trend that will continue as now the domestic market in these countries is satisfied and in order to continue their expansion these countries must look to other markets – mostly in the 'South' – to grow further. As new users of these products there is more thorough explanation required to ensure they understand exactly what the product is meant to cover and how it works. It might seem more complicated from the bank's standpoint, but the risks are not necessarily increased. The only factor that may be of importance, not something the market has seen but something that has been suggested is that these non-OECD companies may have less stringent standards in relation to things such as environmental regulations. This is something that insurers must evaluate as it does add extra risk."

In terms of which countries are generating the most enquiries for insurance coverage, Palmer at BPL Global points to Russia as leading demand at the moment: "Some of this is lenders' cover for banks, insuring against loans not being repaid due to political events such as expropriation, currency inconvertibility or war. Cover against non-payment and non-honouring of letters of credit is also popular. And we are seeing strong demand for similar coverage in Ukraine."

Coverage for Iran centres on the non-honouring of letters of credit, those underwriters not subject to US sanctions are still able to cover Iranian risk, so there is still some availability for that. In China, Palmer points to a range of different types of enquiries from capital goods business to the non-honouring of LCs, mainly from the public banks though with some private sector credit risk. Indonesia again sees a wide range of demand including non-honouring of LCs and pre-shipment risk for exporters.

Globally, strategic equity investors typically seek expropriation and political violence coverage, while lenders seek currency inconvertibility and expropriation of funds cover. Those investors involved in infrastructure transactions may also require breach of contract or arbitration award default coverage.

The growing number of what some term 'para-statal' enterprises in emerging markets – joint ventures between government corporations and foreign private companies – poses a unique challenge for both foreign investors and insurers. Banks making loans to these emerging market projects supported by sovereign or sub-sovereign guaranties actively seek so-called 'non-honoring coverage' from insurers. This type of coverage is presently in high demand in the market. But should default occur, is the risk political or commercial?

Changing demands

As this line between political and credit risk blurs, Marsh's Watson notes that buyers of insurance are increasingly looking at concentrating their risk by blending pure political risk cover and pure trade credit insurance cover: "I would term this as trade risk related insurance and there are definitely sectors that are particularly active with this blend: the telecoms sector, power, mining, and oil and gas. This is largely related to infrastructure projects and other investment in emerging markets. Through this, the understanding of emerging market risk has improved."

One way of thinking of political risk, is to have investment risk at one end of the spectrum, in terms of investing in infrastructure projects, and actual risks associated with trading at the other. Similarly on the trade credit risk scale there is the total portfolio approach at one end of the spectrum and case-specific risks at the other end. Those specific risks, whether they are single buyer-related or specific to the locale or region of the investment, are at the crossover between credit and political risk. Insurers have seen a demand

from corporate clients to look at those risks together and find solutions that fulfil requirements for both together – comprehensive cover as opposed to just private political insurance.

According to Riordan, Zurich has also seen a rise in interest in its medium-term trade credit coverage. This coverage is important to exporters and banks which have exposure to political and commercial risk in financing trade transactions involving private obligors in emerging markets.

BPL's Palmer cites the Argentina currency crisis as one event that forced banks to sharpen their approach to insurance: "There were some banks that had problems following the corralito in Argentina. When they bought insurance they wanted cover against the country risk. Their definition of country risk was not always the same as their insurer's definition of political risk. The problem was that a lot of those banks were buying on a direct basis, as a tick-the-box exercise to satisfy their credit committees. Going direct without a specialist broker as an intermediary they did not have the advice they needed in terms of what exactly was or was not covered. When the currency devaluation happened they found that their borrowers were struggling to repay as they had to find twice as many pesos as they previously needed to. Is that a political event or is that commercial? We advise our bank clients to insure on a comprehensive basis – covering both commercial risk and political risk – wherever possible."

This increasing sophistication is why many insurers saw a benefit in aligning their trade credit and political risk practices. The demand for both insurance solutions for local-driven risk, such as a US corporate looking to cover the development of a manufacturing plant in Ukraine, and also cover for the corporates overall global trade means that insurers are working towards understanding how to develop a better product offering. It is also important to note that buyers of insurance are increasingly doing their own research regarding the inherent risks of trading in individual markets.

"Risk management is more closely scrutunized than ever before. The 'devil is in the detail' mantra applies not only to the insured trade but now also to the insurance policy itself. With banks becoming more sophisticated buyers of insurance, insurers have been forced to adapt their offering," says Underwood at Hiscox Global Markets, which offers two main types of policy covering both assets (including collateral deprivation, confiscation, nationalization, forced abandonment etc) and trade transactions (embargo, war, licence cancellation, non-payment etc). Underwood has previously noted that insurers are looking to provide coverage for the unforeseen, not the inevitable. A political risk policy is not designed to respond to the customary perils of how life is in a particular country.

Regulatory change

Not just through previous experience are insurance buyers becoming more sophisticated. Banks are coming in with different requirements driven by new regulations such as Basel II. This is becoming especially important as it must be taken into account when new policies are written. The offering has to be valuable for the buyer going forward as well as in the present. On the buyer side, banks and corporates are in the process of having these new policies looked at and are working out internal policies in terms of political and credit insurance.

"Basel II could prove to be a real impetus in driving people to buy insurance in the private market. It could be one of the most important things to happen to the market in 20 years. It will make insurance products better for the banks," comments Underwood.

Westholm-Schroder at Sovereign agrees: "Basel II is certainly driving demand for business, with banks re-evaluating political risk and becoming increasingly sophisticated in their demands. Our view of Basel II and the new rules is that with straight political risk insurance, for export-type financing and non-payment coverage, as opposed to comprehensive coverage, we believe that the comprehensive form will fair a lot better under the new rules than under it has under the Basel I rules. This does depend on who you are getting insurance from, what the contract and policy looks like."

There are banks that say that what they would like to see from insurers is more of a guarantee than an insurance policy. Under Basel II a properly drafted insurance policy can qualify as a 'guarantee'. In a traditional guarantee structure a party provides a guarantee when it has a relationship with the counterparty. So, if a lender is concerned about credit risk, a guarantee from a party with a direct relationship with the counterparty makes sense. An insurer, however, does not have a relationship with the counterparty.

Palmer at BPL explains: "Now, some insurers are offering banks unfunded risk participations which read much like a guarantee. These are really conditional ➤

➤insurance policies as the insurer doesn't have a direct relationship with the obligor/borrower and it has to rely on the party being insured to provide the information on the obligor/borrower and the underlying obligation. The basic insurance concept of utmost good faith applies so the rules of disclosure and misrepresentation must be understood and respected. What banks need is expert advice on how to deal with these issues. When properly handled, insurance policies are a very efficient method of laying off emerging market payment risk, as our claims statistics prove: 95% of the non-payment claims we have received have been paid in full, totalling nearly $450 million over a period of 23 years. The few that were not paid in full were compromised by the insured's operational failure or resulted from the insolvency of the Australian insurer HIH whose security had been approved by the insureds when they took out the policies."

Looking forward

So how long will this buyers' market last? If, as has been suggested, the bottom of the market in terms of pricing has already been reached, then how will the market react to the next crisis or a general change in economic conditions?

Referring to the UK market, Joe Blenkinsopp, head of London markets at Coface UK comments: "The trade credit insurance market in the UK is experiencing fierce pricing competition and certain insurers are writing policies which cannot possibly be profitable in the short to medium term, the market is seeing a worrying increase in payment default and the consequential influx in potential claims notifications. Within the next 12 to 18 months we expect to see the most aggressively priced policies having their credit limits and coverage restricted and cut back by these insurers in response to mounting losses."

Coface UK has been stepping back from some of this more aggressive competition for existing market share and, not wanting to raise clients' expectations unrealistically, not quoting on the most keenly priced deals. They are concentrating on developing new business to the market and preserving long term value added relationships with their existing clients.

Blenkinsopp continues: "The political risk market has recently seen some substantial losses although despite this there appears to be very little change in the majority of the market's appetite to take on more risk at competitive pricing. Many claims have been paid out over the last year and whilst this is good to be able to prove that the products work well it does leave one wondering how long this competitive premium market can last."

Says Underwood at Hiscox: "If there is a big smash up of some sort, liquidity will tighten once again and this will directly affect the insurance market. One way that Hiscox is preparing for this is by raising the bar on obligor risk which will reduce the availability of coverable counterparties. In the event of a credit event this will mitigate the impact on both insured and insurer."

This raises the question of where the next claim will come from and what will trigger it. As has become evident in the insurance industry, whether the trigger is war, the bursting of the commodity bubble, a credit crisis, terrorism, a pandemic, an embargo, fraud, civil unrest or natural disasters – many are linked and all have the possibility of triggering a downturn in the global economy. The level of losses made by companies over the coming years could be very different from the recent past. Many of these risks can be addressed or mitigated through political and credit risk insurance.

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Underwoods notes: "What will turn the market is either prices deteriorating to levels where risk takers are no longer interested or a series of losses."

Capacity and liquidity in the banking market is still readily available, however, there are signs of an upturn in bank pricing for some markets. This may well feed into even greater demand for the political risk market products as banks arbitrage the market pricing to maximize returns.

Now is the time for banks and corporates to check their insurance policies. Until a trigger event occurs this is a good time to buy insurance, but not a time to forget the maxim that no one will insure a burning house. ■

A view from the insured

An export finance banker writes:

We are witnessing a growth in the credit insurance market. The ability to provide tenors beyond 3 years and to assume credit risk is key to the growth in these markets. Political risk alone is not sufficient. As a bank we have not actively purchased political risk as it fails to provide protection against devaluation. We are though always reviewing credit insurance markets that may provide solutions on an untied basis and be complimentary to an agency solution or standalone.

We are also all witnessing the enormous growth in the credit default swap (CDS) market. This market also provides risk protection, both political and credit risk, and is able to provide meaningful amounts and tenors for hedging of corporate and sovereign risks.

The universe of risk takers is also changing and growing with non-bank investors particularly prominent such as hedge funds and other institutional investors.

In addition, the increase in local currency financing is also a natural development and eliminates the need for many of the risks involved in political risk such as currency transfer and convertibility. We have even seen most recently the EBRD complete an A/B loan in Russian roubles for the Mosenergo power and utility company in Moscow as evidence of the growth in local currency financing. This was a seven-year B loan and we expect tenors to lengthen further in the future.