International Political Risk Management
Looking to the Future
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Theodore H. Moran and Gerald T. West
Editors

The World Bank
Washington, D.C.
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Preface

*International Political Risk Management: Looking to the Future* is an outgrowth of a symposium held November 12, 2004, under the joint auspices of the Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group and the Karl F. Landegger Program in International Business Diplomacy at the School of Foreign Service at Georgetown University. It is the fourth in a series of volumes based on this biennial symposium. Like its predecessors, this latest symposium brought together senior practitioners from the investor, financial, insurance, broker, and analytical communities to discuss and assess the key issues confronting the international political risk insurance industry.

The large and diverse audience (more than 160 people from 35 countries) actively participated in the discussions of the eight commissioned papers and presentations at the symposium. In response, the authors revised and expanded their papers for this publication. In addition to writing four sectional overviews, the editors have sought to capture the rich quality of the discussion that followed each presentation through four discussion segments, presented in a question and answer format.

MIGA’s objective is to facilitate the flow of foreign direct investment to developing countries by alleviating investors’ concerns about noncommercial risks. MIGA has always pursued this objective in a variety of ways. In addition to providing political risk insurance to investors and offering technical assistance in attracting investment to host member countries, MIGA has selectively sponsored research on the challenges of assessing and managing political risk. The symposium and this publication represent part of these larger risk mitigation endeavors.

The Karl F. Landegger Program in International Business Diplomacy at the School of Foreign Service at Georgetown University conducts teaching and research on the intersection of international
corporate strategy, public policy, and business-government relations. The program has active teaching and research programs devoted to political risk management techniques that may be useful to international investors and host governments alike.

Our two institutions share many objectives, including the desire to promote productive foreign direct investment that can enhance the growth and welfare of developing countries. Our common hope is that readers will find that this volume contributes to that objective.

We are grateful for the support this symposium and volume received from Lola Brown and Kathleen Klingenberg at Georgetown and from Kristofer Hamel at MIGA.

Theodore H. Moran
School of Foreign Service
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Gerald T. West
Multilateral Investment Guarantee Agency
World Bank Group
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<th>Acronym</th>
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<td>AAA</td>
<td>American Arbitration Association</td>
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<td>Overseas Private Investment Corporation</td>
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<td>UNCITRAL</td>
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I am delighted to introduce this volume in the *International Political Risk Management* series. The papers and commentary in this volume are based on the discussion among the 160 participants at the most recent Symposium on International Political Risk Management hosted by MIGA and Georgetown University, held November 12, 2004. It is the aim of this volume to present to the reader a concise account of the dialogue and discussion that occurred during the symposium.

For MIGA this series serves as a forum for discussing and promoting best practices and latest developments in the investment insurance industry. Our founders specifically included in the MIGA Convention a mandate to “carry out research, undertake activities to promote investment flows, and disseminate information on investment opportunities in developing member countries with a view to improving the environment for foreign investment flows to such countries.” MIGA has traditionally worked with many of the participants of the symposium: with investors, through the provision of coverage on projects; with other insurers, through coinsurance and reinsurance; with brokers, in identifying deals; and, of course, with our many public sector partners. We are now fortunate to work with these partners to add to the growing body of knowledge that guides the political risk insurance industry.

In the spirit of cooperation and the free exchange of knowledge, let me offer some preliminary thoughts that highlight MIGA’s interest
in convening this symposium. The past four years have been difficult for international investors: foreign direct investment (FDI) flows into developing countries have fallen by more than a quarter over the past five years, from an all-time high of more than $180 billion in 1999. Many reasons can be cited for this phenomenon: the financial crises in Latin America, depressed growth in many OECD countries, the September 11 terrorist attacks in the United States and their aftermath, and the on-going conflict in many areas of the world, especially the Middle East. In addition, the first big wave of privatizations has ended in many larger emerging markets, and many foreign investors in regulated industries, such as the power industry, have become embroiled in disputes with host country governments. In aggregate, these factors have had a significant negative effect on global investment flows.

We must resist the temptation to draw conclusions about the investment insurance industry from the volume of FDI alone, however. When we further examine our view of FDI flows, we find two streams of investment flowing to emerging markets. On the one hand, the overall distribution of FDI against the income and risk rating of our developing member countries shows that more than 30 percent of flows go to low-risk, low-income countries. On the other hand, only 12 percent go to high-risk, low-income countries. It is clear, therefore, that risk factors have influenced investors’ decisions to seek out opportunities in developing countries. By finding ways to mitigate these risks, we—as professional risk mitigators—can provide real value to both international investors and host countries.

A varied picture of investment also emerges if we look across sectors. Some developing countries, such as India and the Russian Federation, have been able to benefit from strong growth in investment in the services sector. As many companies and organizations—including the World Bank Group—have shifted back-office functions to emerging markets, there is clear growth potential in this sector for some countries, particularly those that have been investing in education and the vocational expertise of their population. But in other sectors, such as infrastructure, the decline in FDI has been steep. From a high of $128 billion in 1997, private infrastructure investment into developing countries fell by nearly two-thirds, to just $47 billion in 2002. Moreover, investors and banks are becoming increasingly risk averse when it comes to developing country exposure. In recent years, U.S. banks have virtually withdrawn from project finance transactions in the developing world, and many
domestic banks that were traditionally lenders have been focusing on shoring up their capital adequacy.

These developments have caused many observers to be pessimistic about prospects for investors and host countries alike. Despite these trends, I am becoming more optimistic about the future—and the economic fundamentals would appear to support this view, for several reasons. First, stronger growth in OECD countries, and the search for new markets and production sites, should finally begin to push FDI numbers back up in the coming years. The International Monetary Fund and others have predicted a modest recovery in 2004 and 2005.²

Second, many developing countries have been taking much-needed measures to improve the investment climate in their countries. More free trade agreements are being put into place, and there is increased regional integration among groups of emerging economies. According to the United Nations Conference on Trade and Development, 95 percent of the many regulatory changes introduced in 70 countries in 2002 were favorable to FDI.³

Finally, the needs are so great in emerging markets that one can reasonably expect investors to seize opportunities in a number of sectors in these countries. In infrastructure alone, for example, the annual need for new investment is estimated to exceed $230 billion⁴—and this does not include maintenance expenditures. The rapid growth of urban population centers such as Shanghai, Mumbai, Cairo, and Mexico City is putting extraordinary strains on all actors to provide both potable water and wastewater treatment. In many regions of the world, particularly Africa, basic infrastructure—power, roads, and telecommunications—remains inadequate, making living conditions very difficult for the poor and impeding the growth of the domestic private sector and the inflow of FDI. Clearly, developing country governments will not be able to shoulder the burden of financing these needs alone. Foreign investors have a huge opportunity to make profitable investments in these areas.

As someone who has had a long career in investment banking, my early experience at the helm of MIGA has only solidified my conviction that profitable, developmentally sound investment opportunities abound in developing countries. In Africa, for example, the economic outlook and prospects for increasing foreign investment flows is encouraging, especially given the natural resource potential, buoyant commodity markets, and improving investor perceptions. Growth in 13 of the continent’s 47 countries averaged more than 5 percent in recent years. And 36 countries saw a rise in FDI inflows in 2003.
The key to converting these opportunities into investments, jobs, and incomes for the poor will be for all of us—investors, banks, host countries, and development institutions—to work together. We all have a vested interest in promoting good projects that help strengthen host countries, because doing so reduces risk, which benefits us all. Investments that support sustainable development and adequately integrate responsible environmental and social practices lead to better long-run returns for investors and host governments alike. By leveraging our respective strengths and building strong partnerships, we can more effectively mitigate risks and work toward increasing the volume and improving distribution of FDI.

The task of increasing and diversifying FDI flows is daunting, especially against the backdrop of immense needs and staggering risks. Our industry must address new challenges in order to better service its existing clients and create products to meet new demand. How do we deal with public-private partnerships and subsovereign risks? What can be done to allay investors’ fears about currency devaluation and terrorism? How do we tackle these needs while making our businesses profitable and our insured investments beneficial to host countries?

The answer to these questions can be found only through analysis, experimentation, and discourse among practitioners. The ideas and insights presented in Looking to the Future represent an effort by the investment insurance community to do just that. Through papers and discussion, seasoned industry leaders grapple with the future of our industry. Their message to us is clear: with appropriate risk management mechanisms, there are tremendous opportunities for investors to make profitable, productive investments that will also benefit poor people throughout the developing world.

Notes

In Part One, two veteran participants in the political risk insurance industry offer their perspectives on lessons that may be learned from recent losses, near claims, claims, and arbitrations. In the first paper, “Tales from the Dark Side: Lessons Learned from Troubled Investments,” Kenneth Hansen, a partner at Chadbourne & Parke LLP, notes that the past five years have been rich in troubled investments that have spawned a spate of political risk insurance claims. Other projects have required debt restructurings in which the presence of investment insurance was among the factors that needed to be considered in designing the terms of the restructuring. Hansen then draws lessons for the effective design and drafting of political risk insurance contracts from both sets of investments and offers counsel to investors as well.

He provides a brief overview of the history of the political risk insurance industry, observing that some of its basic products were designed to deal with threats that have become increasingly rare. Despite this change, the tendency in the industry has been to try to hold onto the traditional formulations, with some modification, and to try to “find” coverage in the wording of existing contracts. The expansion of private political risk insurance coverage that occurred in the mid- to late 1990s was not empirically based but was due to the successful track record of the leading public agency insurers during their
years of operation. Conservative commercial insurers preferred writing the same kinds of coverage as public insurers rather than developing new forms of coverage.

The nature of the investment disputes and claims that are arising today do not match the traditional coverages very well, asserts Hansen. As a consequence, there has been a dramatic increase in the number of contentious claims and a dramatic decline in the number of claims paid without litigation or the threat of litigation. When insured investors encounter severe problems, they have tended to turn to their legal counsel with demands that they “find” coverage in their existing investment insurance contracts. The mismatch between the scope of the coverages investors want and what insurers have supplied has fueled tension in the market that comes to a head when claim and near-claim situations arise.

Hansen notes that while many matters are still in arbitration, the number of investment disputes suggests that there is a sound basis for drawing many lessons. He considers both actual political risk insurance claims filed in conjunction with host governments and project loan restructurings in which the investments are insured against political risks but have not given rise to claims.

With respect to actual political risk insurance claims filed in conjunction with host governments, Hansen organizes the lessons learned (for both insurers and insureds) under seven terse aphorisms, each of which he treats in some detail:

1. Political risk insurance works better when coverage is clearer.
2. Be careful what you promise.
3. In perfecting a claim, do not depend on things beyond your control.
4. Watch out for quirky causation standards.
5. Avoid confidentiality provisions.
7. Political risk insurance of arbitral awards helps.

Hansen observes that many insured investments have encountered difficulties that, although not the basis for a political risk insurance claim, have required loan restructurings.
These project loan workouts are a rich source of lessons regarding the effective design and drafting of political risk insurance policies and a source of lessons for those involved in financial restructurings. Hansen insightfully notes that existing political risk insurance coverage can be both a resource and an impediment to the restructuring.

With respect to political risk insurance as a resource, on the one hand lenders may be comforted by the presence of at least one risk mitigation component. Moreover, to the extent that coverage may be transferred to new parties, such as new lenders, it can be a very valuable asset. On the other hand, political risk insurance can also hinder a successful restructuring. Hansen identifies no less than seven such difficulties that could arise, and he draws on his experience to suggest some creative ways of addressing each. Particular attention is paid to intercreditor issues, material amendments, and “reasonable consent” from the insurer for the rescheduling.

Hansen concludes that the fundamental lesson learned from recent claims and troubled projects is that political risk insurance works. Questions about the relevancy of the political risk insurance industry, raised in the wake of the Asian economic crisis, have been answered: the industry has proved itself through its record of claims payments. It has been reinforced by recent innovations and adaptations of the terms of traditional coverage in response to contemporary demands arising out of various types of public-private partnerships.

In “Learning from OPIC’s Experience with Claims and Arbitration,” Robert C. O’Sullivan presents an analysis of OPIC’s extensive claims experience, based on 279 settlements totaling $914.7 million as of September 30, 2004. (OPIC denied 25 of these claims, 12 of which went to arbitration. OPIC has paid more than 90 percent of the claims in which final determinations have been reached.)

While OPIC’s claims experiences mirror some trends in international investment activity, there are some significant differences between OPIC’s experiences and that of political risk investment and insurance industry. O’Sullivan acknowledges that OPIC’s experience is not necessarily representative of claims in the political risk insurance industry, since it excludes investors, projects, and countries that were ineligible.
Theodore H. Moran and Gerald T. West

PART ONE

for OPIC coverage. In China, for example, OPIC opened for business in 1981, withdrew eligibility in 1989, and has not written a policy since. Mexico and India have only recently become eligible for OPIC coverage.

Nonetheless, certain trends in OPIC’s claims experience are noteworthy, including the shrinking percentage of inconvertibility claims experienced, the increasing number of political violence claims, and the predominance of expropriation claims. According to O’Sullivan, these developments are changing insurers’ expectations for mitigating and resolving investment disputes.

O’Sullivan insightfully draws many lessons from OPIC’s claims experience for both underwriters and investors. On the one hand, he notes that the process of making a claims determination can be a learning experience, because it focuses attention on issues that may have been overlooked or not fully understood. Political violence claims, for example, led OPIC underwriters to understand that projects involving perishable products carry more risk than projects that do not involve perishable products. On the other hand, investors sometimes learn lessons that turn out not to be particularly useful: the overthrow of the Shah of Iran led many companies to seek billions of dollars of expropriation risk coverage in Saudi Arabia, for example.

Claims determinations can create quandaries. OPIC does not insure existing investments, but it does insure expansions and acquisitions. If an entire enterprise is expropriated, how should the insured and uninsured portions of the total valuation be divided? O’Sullivan notes that there are some very practical difficulties of answering this question.

Increasingly in the contemporary period, observes O’Sullivan, it is no longer enough to merely analyze the risk for the coverage requested. OPIC has concluded that “understanding the deal” is more important than previously appreciated. Underwriters need to understand the financial and business aspects of the project to make better decisions about whether the basic contracts fit or whether there is a need for special purpose amendments.

Claims determinations can be very time-consuming. OPIC spent eight years of arbitration and litigation on a single project. It prevailed, but it absorbed legal expenses that were far
greater than any prospective premium income, expended a huge amount of staff time, and lost goodwill in the process.

What lessons can be learned from “near claims”? O’Sullivan notes that OPIC insurance contracts oblige the insured to alert OPIC of events that could give rise to potential claims. This is because lack of notice might prevent OPIC from taking steps to head off a claim or at least accumulate information about the situation. Often enlisting other U.S. government agencies to join in “advocacy,” OPIC has a strong record of helping resolve some investment disputes and averting potential claims in others. But advocacy also carries dangers, including operating on insufficient or erroneous information supplied by the claimant. Advocacy on behalf of individual investors may also lead to accusations that OPIC ignores the “larger picture.” In some cases, for example, foreign governments have had to take actions that adversely affect covered investors as part of general austerity programs imposed by the International Monetary Fund and backed by the U.S. government as a matter of official policy.

What lessons can be learned from claims denied? OPIC procedures allow claimants the opportunity to make their best case; if the Corporation nonetheless rejects the claim, OPIC allows the insured to review the decision in draft and comment before the determination becomes final. On occasion, OPIC has been persuaded to change its position based on comments made on a preliminary draft.

The most basic question is whether the events or actions that precipitated the claim are covered by the insurance contract. Disagreements relating to the scope of coverage hold valuable lessons for the insurer in drafting and negotiating future contracts. Some disputes involve basic aspects of coverage; more difficult are amendments that restrict the scope of coverage. When a dispute arises some time after the contract was written, the insurer, insured, and arbitrators may not have a common understanding of what specific amendments written long ago were designed to accomplish, why they were written, or how they were intended to work. With this in mind, the author notes that the most important lesson from the claims-denied experience is also the simplest: the insurer should give fair weight to the insured’s arguments, be realistic about the impacts of an
error made by the insurer, and anticipate a third party’s reaction to the arguments made by the insured and insurer.

What lessons can be learned from claims-related arbitrations? OPIC contracts provide for disputes to be resolved by arbitration under the American Arbitration Association (AAA) commercial rules. The AAA has assigned arbitrations to the International Centre for Dispute Resolution, which has great familiarity with international projects and political risk insurance claims.

The principal advantage of arbitration, in OPIC’s view, is the ability to select an expert, or panel of experts, with appropriate knowledge and experience. But this requires identifying what the key issues in a complex case will be, which is not always clear at the outset; sometimes the required expertise has turned out to be quite different from what OPIC judged when it helped set up a given arbitration panel. OPIC’s experience in picking individual experts, moreover, has included what O’Sullivan calls “some unhappy surprises.” A drawback of arbitration is that the panel can come to a binding determination that is not subject to review in the way a court decision is, and the decision does not have to be a reasoned one.

Arbitration can lead to changes in OPIC’s contracts. In what O’Sullivan calls a “notorious” case, the expropriation of ITT in Chile took place amidst allegations that the company had taken part in attempts to overthrow the government. OPIC’s contract contained no explicit basis for refusing payment under such circumstances. Since then, all OPIC contracts are written with a provocation exception.

As of September 30, 2004, OPIC had achieved recoveries of $740.0 million, or 81 percent, on total claims settlements of some $914.7 million. For inconvertibility claims, OPIC relies on agreements with host governments to convert local currency into dollars paid to insured investors. OPIC bears the risk of devaluation of the local currency. Expropriation claims are pursued through negotiations with the host governments involved, resulting in deferred payments that those hosts have honored. Intergovernmental agreements between OPIC and host governments allow for international arbitration, but until recently OPIC has managed to gain recoveries without going to arbitration. However, in November 2004 the U.S. government served the government of India with a request for arbitration.
of OPIC’s international law claims arising from payments made by OPIC to equity investors and lenders with respect to the Dabhol power project. This marks the first time that recourse had to be made to international arbitration to resolve a dispute arising from the U.S. government’s investment guaranty program.

Provision of political risk insurance coverage can be most effective, concludes O’Sullivan, if the writing of contracts is constantly informed by lessons learned from the insurer’s claims and near-claims experiences.
Emerging markets—particularly Indonesia, Pakistan, Thailand, the Russian Federation, and Argentina during their respective economic crises—have been a rich source of troubled investments. Some spawned a spate of political risk insurance claims. Other projects required debt restructurings in which, although the conditions for claims were not met, investment insurance was among the factors that needed to be considered in designing the terms of the restructuring. This paper identifies lessons for effective design and drafting of political risk insurance coverage drawn from troubled investments, from both projects that gave rise to claims and loan restructurings that involved investment insurance.

Contemporary investment insurance against political risks traces its origin to the Marshall Plan, under which the U.S. government offered to insure certain risks for U.S. investors venturing into post-war Europe. Those insurable risks included currency inconvertibility (beginning in 1948), expropriation (beginning in 1951), and political violence (beginning in 1956). No statistical modeling supported the program’s pricing or its feasibility as a business. Rather, the program’s birth reflected the commitment of the U.S. government to invest in rebuilding Europe and, in due course, recovering and developing countries worldwide; its preference to allocate some of the related costs to private investors; its expectation that, even if some of those investments ultimately became public expenditures (through payment of claims), the likelihood was slight that there would not be at
least some net redistribution of the costs of reconstruction and development from the public sector to the private sector; and its belief that success in inducing investment would promote development, deter economic and political crises, and thus reduce the likelihood of claims. Consequently, the sort of statistical modeling that underlies the pricing of, for example, automobile collision, health, or malpractice liability insurance was not part of the origin of the political risk insurance industry, and it has not since become part of it.

Rather, the empirical foundation for the expansion of private sector coverage that occurred in the mid to late 1990s was the profitable track record of the leading public agency insurers throughout their years of operation—the Overseas Private Investment Corporation (OPIC) from 1971 and the Multilateral Investment Guarantee Agency (MIGA) from 1988.7

The market welcomed the expansion of the private sector in the 1990s, in the hope that commercial providers would be free of the statutes, charters, and policies that constrained the agency providers. That expectation has largely been met in terms of timeliness of turnaround. With respect to breadth of coverages, however, the historical rather than analytical basis for commercial issuer operations naturally introduced a conservative bias to their products. That is, the commercial insurers prefer doing what the agencies have already proven can be done profitably.

A dominant theme of the last two symposia was the evident mismatch between the demand and supply sides of the market with respect to scope of coverages. With agency providers offering products designed primarily to deal with the salient investment risks of the 1950s era, and commercial insurers offering products substantially identical to those of the agencies, the emergence of a mismatch is not surprising. For instance, the market wants to mitigate government breach of contract or regulatory changes, while the supply side sells expropriation insurance that traditionally has carved out such breaches and regulatory risks from its coverage. The demand side of the market wants to mitigate the risk of currency devaluation, while most currency risk coverage specifically carves out depreciation and devaluation.

Against this backdrop, I am hopeful that a theme of this year’s symposium will be the diminution of the mismatch. There are good grounds for believing that this is happening. For purposes of this paper, however, we should consider some consequences of the mismatch in the investment insurance market.

The most obvious consequence is that some investors failed to get the coverage they wanted, which may have stood in the way of
some projects going forward. More typically, however, investors might have taken whatever coverage they could get. The consequence of these actions is that investors spent billions of dollars insuring against expropriation and currency inconvertibility, while the real risks they feared were contract breach, regulatory risk, and devaluation.\(^8\)

To the extent that such investors correctly perceived the prevalence of these risks, and related losses came to pass, the stage was set for some further tension in the marketplace over potential and filed claims.\(^9\) One group of insured investors ran afoul of these uninsured risks and asked the question, “Why do we bother with political risk insurance if it does not cover the risks that are causing us problems?” Thus arose a strain of commentary that, since the Asian economic crisis, has asserted that political risk insurance is irrelevant. Nevertheless, this paper concludes that those concerns have now been addressed, both by a series of claims payments and by useful evolution of the coverages now available in the market.

A second, perhaps overlapping, group of insureds instructed counsel to be creative and aggressive by stretching actual coverage to reach arguably uncovered circumstances. Insurers naturally resisted paying such claims, which yielded a spate of arbitrations. Pursuing such a strategy has paid off well for some insureds. For instance, in the arbitration by General Electric and Bechtel, as insureds, against OPIC in connection with their investments in Enron’s Dabhol power project in India, the arbitral panel chose to honor the insureds’ claims, notwithstanding their clear failure to satisfy a series of risk-mitigating provisions that OPIC had included in its contract.

In a third class of cases, more traditional coverage disputes between the facts and the policies are in the process of being arbitrated or otherwise settled. A fourth group of cases comprises a substantial number of claims that have been filed, proved, and paid.

These cases, particularly those in the second group, have given rise to discussions, both in the pleadings and more generally in the industry, as to just when government breach of contract (which was not explicitly insured) is “tantamount to expropriation” (which was covered). Similar discussions have arisen with respect to when disruption of currency markets (which was not covered) may be the functional equivalent of currency inconvertibility (which was covered).

While many of those questions still linger in various stages of arbitration, the record of investment disputes to date suggests a number of lessons. The first set of lessons concerns political risk
insurance claims filed in connection with investment disputes with host governments. The second covers project loan restructurings in which investments are insured against political risks but have not given rise to claims.

**Lessons from Claims**

Seven important lessons have emerged from experience with claims filed with respect to host government actions.

1. **Political Risk Insurance Works Better When Coverage Is Clearer**

   While insurers are not pleased when a covered risk occurs, they are even more disconcerted when faced with claims for risks that they justifiably believe are outside the scope of the coverage. While all of the evidence is not yet in, one might expect the marketplace to react by clarifying exclusions and limitations on coverage in order to discourage efforts to try to “stretch” coverage.

   The consequence of this mismatch between coverages issued and coverages desired is not that there are more claims—doubtless there are fewer than if insurers had squarely covered the breach and regulatory risks that investors feared, rightly as it turns out. Rather, the consequence is that the claims filed have been more likely to be disputed.\(^{10}\)

   It is ironic that some have argued that these disputes show that the industry resists paying claims. I suspect the reality is that wounded and desperate investors are pressing claims that should have been valid only under coverages that no one was offering and that they therefore never managed to buy.

   Happily, the past few years have seen real progress on the supply side of the market, with greater availability of both breach of contract and nonhonoring guaranty coverage. A likely consequence will be clearer claims that better fit the coverage and that, as a result, are less likely to be contested and more likely to be paid.

2. **Be Careful What You Promise**

   Insureds chronically make promises (regarding the required elements to perfect a claim) that cannot realistically be kept. Prospective insureds need to take the trouble up front to think through in detail the mechanics of the claim process. Are the processes and the requirements consistent with covenants and mechanics under the
financing documents? Each claim I have reviewed has presented some inconsistency between the insured’s obligations under the insurance contract and its rights or obligations under the insured contracts. If coverage is to work well at the time of a claim, its terms need to be considered carefully when the policy and the insured agreements are negotiated.

3. In Perfecting A Claim, Do Not Depend on Things Beyond Your Control

A project lender’s claim under arbitral award coverage may depend on the project company first achieving an arbitral award. Yet the lenders may not have the right either to force the project company to pursue arbitration or to pursue it on their own. Insureds need to think through the claim requirements and mechanics carefully before signing the contract.

4. Watch Out for Quirky Causation Standards

Causation standards vary substantially across (and even within) contracts. The political risk cause of the insured loss may be required to be “direct,” “direct and immediate,” “sole and direct,” or “exclusive.” The Asian Development Bank took the radical step of providing coverage under its new form partial risk guaranty for losses “caused by” the covered risk, without further adverbial limitations. The concern, of course, is that in a complex set of facts, the offending government action will rarely be the “sole” or “exclusive” cause of the loss, which will tend to reflect an assortment of interacting factors.

Some critical factors may well operate indirectly. Suppose the host government instructs the privately owned but publicly incentivized offtaker not to pay amounts due to the project company, and suppose the offtaker follows that instruction. The cause of the project’s resultant loss is clearly the consequence of the government’s action. Assuming that action was wrongful, even expropriatory, was it either “direct” or “immediate”?

Once again the lesson here is to think through plausible claim scenarios and to explore whether satisfaction of the required causation standards could be proved. Although insurers are unlikely to confirm in advance that a particular hypothetical fact pattern would or would not result in a paid claim, it should be possible to explore—and perhaps negotiate—the causation standards.
5. Avoid Confidentiality Provisions

Confidentiality provisions originated from a concern for moral hazard, namely, the prospect that a host government might somehow target an insured project, since the insured investor would suffer little loss. Ironically, at least with respect to the agency insurers, it is widely believed that the prospect of triggering a dispute with the insurer provides an important deterrent to untoward government actions. Deterrence cannot be expected to work well if the deterrent is hidden from the party meant to be deterred.

6. Arbitration Rights Matter

In seeking to enforce an investor’s rights against an offending host government, a threshold challenge is finding a forum with jurisdiction over the government. Another is getting paid if the investor wins the lawsuit. Arbitration rights, which are most likely to be found in project documents or under bilateral investment treaties, may be critical to clearing each of those hurdles.

Recent investment disputes have offered guidance on both the importance and imperfection of arbitration as a dispute resolution mechanism. One lesson, perhaps not too surprising, is that mere arbitration provisions in documents or treaties are no guaranty that governments will go quietly to the appointed forum. To the contrary, governments may use the full array of their considerable resources to defeat the arbitral process.11 India’s infamous Dabhol power project has been the subject of roughly a dozen arbitrations in recent years, most (though, happily, not all) of which remain stymied by court injunctions sought by, and awarded to, Indian government instrumentalities.

If the arbitration manages to proceed to an award and that amount is in the investor’s favor, the investor’s next challenge is obtaining payment. Whether a “responsible” government would fail to pay arbitral awards against it has been much discussed. On the one hand, any government active in capital markets or even utilizing export credit agencies will be concerned with maintaining its reputation for paying what it owes. On the other hand, a government might well be prepared to explain to its underwriters and bondholders that an unwelcome award represents a special, “illegitimate” situation that is appropriate to resist in order to protect the government’s ability to service more deserving creditors, such as its bondholders.
The continued refusal of Pertamina to pay the arbitral awards issued in favor of Karaha Bodas Co., LLC and confirmed by federal district and appeals courts in Texas is cold comfort to any investor expecting to be paid upon winning its case.

The likelihood that a local court will enforce an award that the government is resisting is necessarily low. Even if the winning investor finds government assets offshore, some combination of the doctrine of sovereign immunity and treaties regarding diplomatic protection may leave few such assets available for attachment.

7. Political Risk Insurance of Arbitral Awards Helps

A particularly bright spot in the development of the investment insurance market has been with respect to arbitration award coverage. Insurance of government performance of arbitral awards has been the principal supply-side response to the demand for breach of contract coverage. This coverage is one political risk insurance product that is available off the shelf in a fashion that responds squarely to a key risk, the risk that a host government resists paying an arbitral award against it.

Here the claim payment is not triggered by proof of breach or of damages but rather by the failure of a government to pay an award following the finding by an arbitral panel of a breach and the need to pay damages. Absent such coverage, the winning investor could face years of additional litigation to enforce the award against the government, with no guarantee and perhaps minimal prospects of ultimate success. With such coverage, timely payment is assured.

Investors nonetheless face two challenges in achieving effective coverage. The first is possible frustration of the award process. Standard award coverage requires the investor to prove its case in arbitration. The investor assumes the risk that it may not achieve an award, either because it loses the case or because the case never reaches the point of judgment. Several Dabhol arbitrations have been blocked by Indian court injunctions that the litigants have felt forced to respect. The government of Indonesia attempted to frustrate CalEnergy’s arbitrations against it in connection with the Patuha/Himpurna power projects by the forced repatriation of the government-approved arbitrator. Though the Indonesian government’s efforts to block the process failed, the Dabhol experience to date has adequately demonstrated that a government may well succeed in blocking the process, particularly when the applicant
investors have personal or other interests in countries that are at risk of being held hostage.

Many—indeed, perhaps most—agency and commercial insurers have issued some variant of frustration coverage, on a case-by-case basis. For some programs, frustration coverage is standard. As part of its general expropriation coverage, OPIC’s institutional lender coverage provides compensation for losses as a consequence of any government action that “deprives the Insured of its fundamental rights as creditor.” OPIC recently paid the expropriation claim of the Bank of America arising from the Dabhol project, largely because the government blocked the case from being arbitrated. Even more explicitly, the Asian Development Bank’s standard form partial risk guaranty for project lenders provides coverage in the event the relevant government entity has “either (a) refused to cooperate in the submission of a dispute concerning the breach of a Material Obligation or the repudiation of a Project Agreement to arbitration or (b) frustrated such arbitration by failing to meet its obligations in connection with, or otherwise interfering with, the arbitral process.”

Some insurers have provided such coverage on a negotiated basis, with likely escalation of the applicable premium. Others have been concerned about offering coverage that in effect gives an investor the benefit of the doubt with respect to the merits of the underlying dispute. The recent experience of investors suggests, however, that, although coverage of payment of an arbitral award may be valuable, effective coverage of the relevant risks also requires coverage against frustration of the arbitral process.

The second issue in the arena of arbitral award coverage concerns the nature of the respondent in arbitration: what constitutes “government” and how far beyond core government entities political risks can both reach and be insurable. Both MIGA and OPIC are clear that their liability extends to acts of subsovereign governmental entities. OPIC defines “foreign governing authority” to include, in addition to the central government, “any organ, agency, official, employee or other agent or instrumentality” of either the central government or any political subdivision of the project country. MIGA takes a somewhat narrower approach, defining “host government” to include the central and local governments as well as “any other public authority in or of the host country on which regulatory powers are conferred.” Thus a governmental organ with certain operational responsibilities but without regulatory authority would appear to be captured by OPIC’s definition but not MIGA’s.
A problem arises with each of these insurers, as well as with commercial providers, in which the counterparty on project contracts is not the government per se but rather some sort of quasi-governmental institution over which the government may bear substantial influence, even though the entity is separated from the government. Examples include public utilities, regional authorities, and state-owned or semiprivatized companies. These entities may not fall under the definition of host government under a particular policy, even though they may act on behalf of, or pursuant to direction from, the host government. If the project contracts—and thus the arbitration rights—are with such entities, arbitral award coverage may have little value, since these contracts would not give rise to awards against the host government.18

Investors must review with their prospective insurer the arbitration arrangements under each project agreement. They must negotiate whether an unpaid award would be covered, under what condition coverage would apply, and whether governmental frustration of the attempt to arbitrate would support a claim.

Lessons from Workouts

Not all insured investments that ran into trouble gave rise to claims. The conditions that in recent years spawned a spate of claims also gave rise to numerous loan restructurings for insured projects in which the conditions for claims were not met. These project loan workouts can be tapped for lessons about the effective design and drafting of political risk insurance policies.

An overall observation gleaned from this experience is that existing political risk cover can be a source of both good and bad news for the restructuring—that is, it can be both a resource in and an impediment to the restructuring (often it is both).

Political Risk Insurance as a Resource

Existing coverage will continue to defray some risks associated with the now troubled investment. It assures lenders disappointed by developments in the project company’s credit that they can continue to depend on at least one aspect of the deal’s original risk profile.

If the political environment of the project has deteriorated since the financing closed, the existing coverage may be an irreplaceable asset. Say a $100 million project loan, insured against political risks, is in trouble. The project faces a $20 million cost overrun, and a
bankrupt sponsor is unable to perform its completion guaranty. The lenders agree to swap $20 million of their debt for equity, lowering the outstanding project debt to $80 million. They intend to seek $20 million of fresh senior debt to finance completion and initial operations of the project. Instead of simply losing the benefit of $20 million of insurance coverage on the debt reduction, that coverage could be offered as an enticement to the new money lenders.

The existing coverage is likely to be a bargain, even if the host country’s political environment has not deteriorated. The political risk insurance market would not likely be willing to offer the investors terms equivalent to those offered at the original closing. Insurers, whether agency or commercial, are disinclined to step into a troubled project. The underwriters are likely to believe that troubled projects are more likely to end up in political trouble and that insured investors in troubled projects are more likely to try to characterize essentially commercial troubles as “political” and to file claims.

If the project has already been built, the agencies are even less likely than commercial insurers to offer fresh coverage. OPIC and MIGA, which share the mission of encouraging private investment in developmental projects, would likely point out that new investment in an existing project brings no new jobs, infrastructure, or other developmental benefit. That presumption might be rebutted if the consequence of a failed restructuring would be the shut-down of the project and the loss of the related jobs and other economic benefits expected to come from its continued operation. Such an argument for coverage of new investments in an existing project would be taken seriously, but it would also be examined closely and resolved on a case-by-case basis. If so-called “political-only cover” from an export credit agency were at issue, the agency would normally reject a request for new coverage, on the grounds that it would not create any new exports.

Even though the existing coverage may be a bargain under the circumstances, it may not be worth the cost of retaining it. The lenders will analyze the costs and benefits of maintaining the coverage. The benefits will depend in part on how heavily the lenders weigh the risks that have been assumed by the insurer. Risk mitigation may not, however, have been the sole or even dominant motivation in procuring the policy. The banks may have acquired the coverage because such insurance may lower the loan loss reserves required to be held. Once restructured, the loan may require substantial reserves, notwithstanding the insurance.
Emerging market bond issues have absorbed a great deal of political risk insurance coverage. These bonds were insured in order to pierce the sovereign ceiling—that is, surpass the credit rating of the host government. If the bonds are now headed for a credit default, or even a downgrade, the rating that was the likely motivation for acquiring the insurance may be lost. In such circumstances, the value previously attributable to the enhanced rating will need to be deducted from the benefits attributable to the policy. If the rating was the prime motivation for paying the insurance premium, the restructuring may be the end of demand by the lenders or bondholders for the insurance.

The cost-benefit calculation will also reflect the cost of maintaining the policy. The policy may have been paid in full up front. In that case, maintaining the coverage may be costless. If a premium refund is available, however, the cash back might well serve more immediate needs, such as debt reduction. If premiums continue to come due, lenders may choose to reallocate those amounts to repaying the project loans.

Deciding whether the risk mitigation provided by the policy is worth the price may also involve making a judgment about the likely terms of the restructuring. Will additional parties be brought in? How might they value the political risk insurance?

**Political Risk Insurance as an Impediment**

The presence of political risk insurance in a transaction, especially if some but not all parties are so insured, can also be the source of a variety of obstacles to achieving a successful restructuring.

*Intercreditor Conflicts:* If some project lenders are covered and some are not, attitudes toward particular issues will diverge. For instance, lenders that have currency inconvertibility coverage will be more inclined to be flexible in accepting local currency payments. On the other hand, these lenders may dig in when conventional intercreditor or collateral-sharing terms call on them to share the proceeds of their insurance claims with their uninsured co-lenders, who seek to “free-ride” on the proceeds from insurance claims.

*Assignment Issues:* If the coverage is expected to attract new investors into the restructured deal, it will need to be transferable to them. Such assignments typically require the insurer’s consent. In one circumstance, consent to assign the insurance contract is highly unlikely. OPIC and MIGA each have requirements as to the nationalities of the
beneficiaries of their coverage. Those requirements will not be waived (although consent assignment might be structured around them).

**Material Amendments:** A debt policy will typically prohibit any material amendments to the underlying financial documents without the insurer’s consent. For instance, OPIC’s form guaranty for project lenders provides that “the Insured shall not modify or amend the debt securities or the loan agreement (except amendments or waivers which are of a formal, minor or technical nature only and do change materially any party’s rights or obligations) without OPIC’s prior written consent, which consent shall not be withheld unreasonably.”\(^{19}\) A less restrictive version would restrict amendments to the timing or amounts of insured scheduled payments or to the interest rate. As a practical matter, however, a restructuring will almost certainly affect the dates and amounts of payments. Consequently, the political insurance provider’s consent to certain amendments will very likely be required to close the restructuring.

A special note is in order for insured bond financings. A popular restructuring technique has been to issue replacement securities reflecting the restructured terms. These are likely to constitute entirely new securities not contemplated or covered by the insurance policy. Thus the scope of the insurer’s ability to refuse coverage of the replacement bonds is likely to be greater than in the case of a bank loan that is merely rescheduled. This issue is probably best addressed up front, when negotiating the terms of the coverage. At that point, it may be simple enough to provide that the insured securities will include any replacement securities whose scheduled payment amounts do not exceed those of the original securities. This would reduce the consent problem to roughly the same issues that apply to restructuring bank loans.

**Disclosure:** Policies often require that both the existence and terms of political risk insurance coverage be kept confidential. Depending on the parties that become involved in a loan restructuring, the insurer’s consent may be required to disclose to an interested party the existence of the coverage. For instance, some of MIGA’s lender contracts provide that MIGA can terminate its coverage if “the Guarantee Holder discloses the terms and conditions of the Contract to any third party (other than [the Guarantee Holder’s lawyers, auditors, accountants, financial advisors and government regulators in the country of the Guarantee Holder]) without MIGA’s prior written consent.”\(^{20}\) Although a reasonableness standard applies to MIGA’s disclosures to
host country government regulators, an absolute right to refuse disclosure, on pain of termination, applies with respect to, for instance, interested commercial parties such as new debt or equity investors.

Reasonable Consent: The crux of dealing with political risk insurance in a project loan restructuring is likely to revolve around the insurer’s consent. The common caveat that such insurer’s consent “will not be unreasonably withheld” is important. Absent that qualification, under New York law, which governs many of these policies, an insurer “may withhold consent for any reason or no reason, and . . . no obligation to act in good faith exists to limit that choice.” This is not to say that any insurer would be disinclined to cooperate with a debt restructuring. The point is only that, absent the magic words regarding “reasonable consent,” the insurer has no obligation to limit the grounds for its refusal to go along with a restructuring plan.

Under what circumstances is it reasonable for an insurer to withhold consent? It is reasonable to refuse consent if doing so would put the insurer in breach of any obligations. For instance, as illustrated above with respect to restrictions on consents to assignment of policies, agency insurers have statutory or charter requirements that may limit the terms to which they can agree in a restructuring.

The classic problem in achieving consent from either a public or private sector insurer arises, however, if it sees consent simply as adversely affecting its business interests. Such interests include the likelihood and magnitude of claims.

How could a loan restructuring increase the likelihood that grounds for a claim arise? Since the circumstances covered by the policy develop over time, the risk of a covered event occurring increases if the term of the policy is extended. That increase may be slight, but nonetheless an extension in the maturity date of an insured loan would likely be seen by a political risk insurer as materially increasing the risk of a claim occurring.

Instead of extending a loan’s maturity, the rescheduling agreement might call for past due or current principle payments to be distributed over future scheduled payment dates without extending the final maturity date. While this would probably not affect the likelihood of a claim, it could affect its magnitude if one were to occur. Similarly, a negotiated increase in the interest rate to reflect the increased risk associated with the now troubled loan would increase the size of scheduled debt service payments and thus expose the insurer to larger claims.
An insurer might also be concerned that consenting to a rescheduling would increase the risk of a claim if the political risk profile of the country deteriorated after the policy was priced and issued. If, for instance, the restructuring occurs in the context of a broad macroeconomic disruption (as in Indonesia or Argentina), the insurer might well be concerned that such circumstances could breed political as well as commercial risks. The current environment might be riskier than the insurer would have knowingly accepted at the inception of the transaction. The insurer might welcome being released from the policy and might be tempted to withhold its consent in order to encourage cancellation of the coverage. Consents may thus be most difficult to obtain in the very circumstances in which they are most needed.

Whether the insurer in this circumstance could “reasonably” withhold its consent to the restructuring is, however, a close question under New York law. On the one hand, the insurer has a rational business interest in withholding consent if doing so would enable it to avoid unwelcome risks. On the other, possible deterioration of the political environment is exactly the risk that the insurer assumed upon issuing the policy. However disconcerting the current context, issuing the consent does not worsen the insurer’s situation relative to the circumstances in which it agreed to be at risk under the policy. Consequently, refusing the consent as an exit strategy from deteriorating circumstances might be characterized as exploiting the dire circumstance of the borrower and its lenders to improve the insurer’s own position. Arbitrators might see this as “unreasonable,” regardless of how attractive it might appear to the insurer at the time.

While case law on these issues is thin, and either side could marshal substantial legal arguments, an insurer’s consent rights are not likely to depend on this issue. A project loan restructuring will tend to involve some element of principal rescheduling, maturity extension, or interest rate increase, any of which would require the insurer’s consent.

What happens to the deal if the insurer’s consent is required and could (reasonably) be refused? Lenders have three options. One is to terminate the coverage. Another is to compensate the insurer with an increased premium or adjustments in the terms of the coverage (such as enhanced exclusions) in order to gain the necessary consent. Another option is to structure the rescheduling around the insurance policy terms in order to obviate the need for the insurer’s consent or, equivalently, to make it unreasonable for the insurer not to give it.
Beyond technical legal rights, the market exerts pressures on all parties to achieve any needed consents. The parties may have other transactions pending with each other, as well as an expectation of future deals. Because of the small size of the investment insurance market, reputations can be established or tarnished quickly. Notwithstanding the market’s small size, some opportunity exists to vote with one’s feet.

Better, of course, at least for the insured lenders, would be to avoid the need for seeking consents to a restructuring. A partial solution to the rescheduling problem can be achieved by negotiating up front a degree of flexibility. Some debt coverage contracts incorporate the concept of a “permissive rescheduling,” by defining the term “scheduled payments” to include not only the original schedule but also any replacement schedule that lies within agreed parameters.

The Real World: Collecting data on the role of political risk insurance in project debt restructurings is difficult. Often the very existence of such insurance is confidential. The negotiated terms on which an insurer bases its consent to a restructuring are unlikely to be publicized.

In order to test the preceding conclusions regarding insurer behavior with respect to providing consents in restructurings, I undertook a small, unscientific survey of political risk coverage providers. I approached representatives of a half dozen agency and commercial insurers on a not-for-attribution basis. All but one confirmed that his or her organization had issued insurance on project loans that had subsequently required restructuring for credit reasons. All five indicated that they had consented to the restructurings. None admitted to refusing to consent to any restructured loan, although two mentioned instances in which coverage was terminated in connection with the restructuring. These results appear to support the hypothesis that restructuring subject to the consent of the insurer, “such consent not to be unreasonably withheld,” appears in practice to offer a workable standard for lenders and insurers, one not likely to stand in the way of fixing broken transactions.

Equity Insurance: The discussion so far has focused on debt rather than equity coverage. Though equity insurance is less likely to be a central issue in a loan restructuring, it could be relevant, particularly if that restructuring might be accompanied by claims on the equity coverage.

The proceeds of the equity insurance policy may be pledged as part of the collateral package for the project loans. Lenders should take care that the terms of the restructuring do not violate the terms of the equity policies in any way that might void them or provide a
defense to payment of a claim. An example would be the nationality eligibility requirements for OPIC and MIGA. Imagine that a British bank financed a U.S.-owned project in which the equity investment was insured by OPIC. The equity investor pledged to the bank both the project shares and the proceeds of the OPIC policy. Upon loan default, the bank forecloses on, and takes ownership of, those shares. The OPIC policy would become worthless for want of an eligible insured investor, thus depriving the bank of an element of its collateral (the policy proceeds).

More generally, insured shares that are pledged as part of the collateral package will be more valuable as collateral if coverage follows transfer of the shares. Typically, however, it will not. Aside from the problem of finding an eligible investor, coverage often restricts transference of insured shares without the insurer’s consent. Until recently, MIGA actually went farther and required its written consent prior to the transfer of any shares by the insured shareholder, whether or not the shares to be transferred are themselves insured.23

The equity insurer may have the right to cancel its coverage in the event of the project company’s bankruptcy. Consequently, should a restructuring plan contemplate a prepackaged bankruptcy in which the equity policy is to be among the surviving assets, the insurer’s consent would be required. Otherwise, the insurer could simply terminate the coverage.

An area of some speculation and controversy is moral hazard, specifically, the arguable impact of equity coverage in distorting the behavior of project sponsors in project loan restructurings. The concerns appear to point in opposite directions—enhanced passivity or enhanced aggression—depending on the circumstances. The first effect arises if the insured sponsors are inclined to rely on an expected claim payment as an exit strategy. Their attention and resources are diverted from a full-throttled effort to work with lenders, and perhaps the host government, to salvage the project. The opposite effect arises from the possibility that sponsors will behave so as to maximize the likelihood of a successful claim. If, for instance, they have arbitral award coverage, they will surely go directly to arbitration, wasting no effort on mediation or other attempts to settle the dispute.24

The policies themselves may offer some mitigation of the risk of moral hazard. For instance, they may require the sponsors to act “as if uninsured” or otherwise to mitigate losses. A sponsor that simply retreats from the battlefield could be endangering the success of its expected claim.
In any event, the right lesson is not for project lenders to discourage sponsors from taking out equity coverage. Lenders and insurers typically share a common interest in motivating sponsors to maximize the value of the project. Lenders might, however, want to consider a review of equity coverage in their due diligence process. If incentives appear to be built into that coverage that could prove counterproductive if the project were to run into trouble (particularly trouble that might constitute a basis for the sponsors to file claims), the lenders might want to consider countermeasures. One possibility would be to provide in sponsor support agreements that the sponsors must provide appropriate assistance in the event of a claim scenario, notwithstanding their claims having been filed or paid.

Conclusion

The fundamental lesson learned from recent claims and troubled projects is that political risk insurance works. Questions about the relevancy of the political risk insurance industry that surfaced after the Asian economic crisis have been answered. That relevancy has been adequately proved through the recent record of claims payments. Recent innovations and adaptations of the terms of traditional coverage in response to demands arising out of various types of public-private partnerships, addressed elsewhere in this volume, reinforce that relevancy.25

Notes


7. Related political risk coverage of trade credits provided by expert credit agencies had been available in the market since 1919 for lenders to purchasers from the United Kingdom (through the predecessor of the Export Credits Guarantee Department [ECGD]) and since 1934 from the U.S. Ex-Im Bank to support U.S. sales. Investment insurance against political risks arrived with the Marshall Plan.

9. To be sure, insurers have also correctly assessed the prevalence of these risks, reinforcing their disinclination to insure against them.

10. I have no data on the percentage of claims that go to arbitration—a complete set of such data would be difficult to compile, given the confidentiality provisions in many policies. My hypothesis, however, is that the share of claims that are disputed has been high since the onset of the Asian economic crisis of 1997.


12. See Kantor, op cit., at 1122.

13. OPIC Contract of Institutional Lenders Insurance, Form 234 KGT 5–73 PL (Rev. 10/2000), sec. 4.01.


16. OPIC Form of Equity Insurance Contract, Form 234 KGT 12–85 (Revised 12/03) NS.

17. MIGA Form of Contract for Loans, art. 2.

18. Direct arbitration rights against the host government might also arise, however, under an applicable bilateral investment treaty.


20. MIGA Form of Contract for Loans, Part II, sec 13.5.

21. MIGA Form of Contract for Loans, Part II, sec. 16.2(b).

22. Some coverages may not be cancelable, which creates a set of additional issues.

23. MIGA, General Conditions of Guarantee for Equity Investment (January 25, 1989; Fifth Revision), sec. 25.1(b).

24. The availability of a bilateral investment treaty that offers sponsors an alternative source of recovery (against the host government) in lieu of the successful operation of the project provides similar counter-incentives.

25. Another question left for exploration elsewhere is the impact of political risk insurance, and insurers, on preclaim dispute resolution. MIGA, in particular, has developed an impressive anecdotal record of claims avoided as a result of its timely intervention.
Learning from OPIC’s Experience with Claims and Arbitration

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OPIC has an impressive public record of managing political risk insurance claims. As of September 30, 2004, it had made 279 political risk insurance claims settlements, totaling $914.7 million, and denied 25 claims, 13 of which were submitted to arbitration. It has thus paid more than 90 percent of claims in which final determinations have been reached.

The pattern of claims has changed considerably over OPIC’s history. Sorted by coverage, inconvertibility claims predominate (172 claims, 62 percent), followed by expropriation claims (63 claims, 23 percent), and political violence claims (44 claims, 16 percent).

OPIC’s experience has not been uniform throughout its history. In the early years (1970–78), inconvertibility claims predominated over expropriation claims (51 percent and 39 percent of claims paid). From 1979 through 1990, inconvertibility claims vastly predominated (82 percent of claims paid). From 1991 to 2004, political violence accounted for 59 percent and expropriation claims 37 percent of claims paid, and inconvertibility claims had become rare occurrences (4 percent of claims paid).

Examining OPIC’s claims experience according to types of coverage, one might conclude that the middle period (1979–90) was the

The author expresses appreciation for the editorial assistance of Andrea Keller, an OPIC intern and a student at the Washington College of Law, American University.
most active. Certainly, OPIC made more than half its claim determinations (61 percent) during that period. However, from the perspective of OPIC’s bottom line, the middle period was the least significant, insofar as total claim settlement amounts ($127.8 million) during that period comprise only 14 percent of OPIC’s total claim settlements ($914.7 million). Similarly, the recent predominance of political violence claims may be alarming, but payments for such claims amounted to only 7 percent of the payments made during the most recent period (1991–2004) and just 4 percent overall.

In monetary terms, expropriation claims predominated in 1970–78 (96 percent of settlement amounts) and 1991–2004 (84 percent of settlement amounts). The explanation for their monetary impact is that almost all expropriation claims have been for total expropriation of the insured investment in a project, whereas inconvertibility claims have usually been for periodic earnings on the insured investment, and political violence claims have typically been for the loss of particular items of tangible property, not destruction of the entire project. Expropriation claims pose the risk of catastrophic loss.

Lessons Learned from OPIC’s Claims Experience

What lessons can an underwriter or prospective investor draw from OPIC’s claims experience? Both should bear in mind that OPIC’s claims experience mirrors certain trends in international finance and investment activity, although imperfectly. It is worth noting a few significant divergences between OPIC’s experience and that of the foreign investment community at large. First, OPIC’s experience does not reflect the experience of investors in OPIC—ineligible countries during some crisis years (e.g., much of Latin America in the 1980s).29 It does not reflect the losses of ineligible investors;30 losses on ineligible projects (e.g., those not meeting OPIC’s developmental or U.S. effects criteria);31 or losses of uninsured investors who could have been insured but who perceived no risk (e.g., in Cuba32 or Iran33). A large number of claims in a particular country may be generated by a few projects, as every installment of project debt or every unremitted dividend gives rise to a separate inconvertibility claim.34 The number of OPIC claims in a particular country is, therefore, not necessarily an accurate measure of the relative quality of its investment climate.35

The shrinking percentage of OPIC inconvertibility claims does reflect the greater openness of developing countries to market
mechanisms and foreign investment. Whereas 20 years ago hard currency would have been allocated by regulation, permit, application, or other mechanism, today it is more likely to be allocated by auction or free market forces, thereby replacing inconvertibility risk with devaluation risk. That is not to say that transfer or inconvertibility risk has disappeared. Indeed, the recent imposition of exchange controls in Argentina and Venezuela led to OPIC inconvertibility claims. The trustee in a capital market transaction made a claim in Argentina. OPIC denied the claim, as no efforts had been made to achieve conversion and local currency was not deposited. In Venezuela three claims have been made with respect to amounts due on supplier credits to a Venezuelan buyer. In each case foreign exchange was eventually made available through normal channels, leading to withdrawal of the OPIC claims, but OPIC remains at risk for future payments. If the Argentine claim had been valid and the Venezuelan claims not been averted, OPIC’s claim payments would have been considerably larger than the historical average. Considering the growing prominence in OPIC’s current portfolio of insurance contracts on capital markets, institutional lenders, and other large transactions, any inconvertibility claims are likely to be relatively large, leaving OPIC with more local currency than can be absorbed quickly by the usual recovery mechanisms.

The average share of OPIC political violence claims in recent years can be explained by recurring waves of political violence affecting countries in which OPIC has been active (e.g., Haiti) and the willingness of investors to stay on and rebuild in high-risk environments (e.g., Colombia, Haiti, Liberia, Rwanda, Sierra Leone) with the aid of OPIC insurance. In addition, the expansion of OPIC’s statutory authority to issue coverage not only against loss due to war, revolution, and insurrection but also “civil strife” brought a greater variety of acts of political violence, including terrorism, within the scope of coverage.

The most significant recent changes in OPIC’s claims experience are the predominance of expropriation claims and their altered character. In the past few years, almost all of the insurance claim matters that have required attention within OPIC have been categorized as expropriation claims, whether potential or actual. Claims are not being made for breach of major investment agreements with the host country government or for the taking of totally private sector investments. Rather, most recent claims arise from the complications that occur when countries open up to foreign investment, make the transition to market economies, and deal with financial crises.
These developments create an atmosphere charged with potential investment disputes. Policy reforms of any kind anywhere may be for the common good, but they often threaten politically powerful vested interests. Joint ventures with parastatals always involve a mix of political and commercial elements, and the mix can be altered to the foreign private investor’s detriment. A country that decides only reluctantly to open up its economy to world market forces, competition, and foreign investment is unlikely to stay the course in the face of difficulty. Governments must manage economic crises on an emergency basis. Some will be mismanaged, innocently or not, sometimes with authoritative outside advice. The foreign investor may suffer as a result of policy advice given by its own government or by international financial institutions. In any case, foreign investors ought to have exit strategies. Under the complex changing circumstances described above, making a political risk insurance claim may be the most attractive exit from a situation that is not working out for reasons that can be loosely termed “political.”

Expropriation will not become “no fault” coverage (like political violence), but the factual and legal complexity of recent expropriation claims and the competing political considerations and equities make these claims unusually difficult to resolve at all stages, from claim determination through recovery. At the project planning and underwriting stage, the prospective investor and its insurer should at least be aware of what may be ahead.

**Lessons Learned from Claims Paid**

As a first principle, insurance claims will occur if the risks insured against are real. A claim is not necessarily due to an underwriting mistake. However, OPIC has revised contract forms in light of claims experience. Even more often, there are lessons that the underwriter can learn from resolving claims.

The process of making a claim determination can be a learning experience for the insurer, because a concrete claim may focus attention on issues that may have been overlooked or not fully understood in the abstract. For example, what are the practical implications of providing political violence compensation on the basis of replacement cost for up to three years from the date of loss? What are the implications of the lack of finality in the claim determination or of the administration of a finance facility? Do the measures of compensation fit only certain sorts of tangible property? OPIC’s contracts work well for equipment, but suppose the claim is for the loss of a herd of
that hungry rebel forces killed and ate or for a mango crop that was not harvested due to political violence? These are examples of technical gaps in the contract that can be filled fairly easily in the claim settlement process and perhaps by technical amendments to standard forms. OPIC had to value a mango crop because a chain of events originating in political violence made export sales impossible, causing the investor to lose the entire crop. This claim and other claims involving the impact of political violence upon project operations led OPIC underwriters to the realization that projects whose inputs and outputs are perishable have a higher risk profile than other projects. If political violence causes power blackouts and disrupts customs clearance, imports and exports of textiles will be delayed and no more. The same is not true for raw hides.

Occasionally, a claim not only highlights a gap but also leaves the insurer wondering how it should be filled. OPIC does not generally insure existing investments, but it has always been willing to insure expansions and acquisitions. A claim focused attention on some practical aspects of doing so. In the event of expropriation, the entire enterprise will be taken, not just the expansion. How should total valuation be allocated between the uninsured and insured portions of the project? How should the new, insured investment be weighted against the original investment and reinvested earnings upon it? How should the resulting claim against the foreign government be apportioned, and how should one determine how many shares represent the insured investment (and should be assigned to the insurer)? If an expansion or acquisition, in business terms, amounted to an effort to save or resuscitate a failing business, should the “new money” be accounted for separately? If not, the net book value of the insured investment may be negative from the date the investment is made. Is this the right result? If so, is the insured aware that premiums are being paid with no prospect of compensation until and unless the project is turned around financially?

New “greenfield” projects hold their own surprises for political risk insurers. Many contracts insure payment flows, such as lease payments or debt repayments, against default as a result of a covered political risk. If a project has enough of a financial history to provide strong evidence that the project was not financially viable and could not have made payments in any event, compensation could be denied for failure to meet the fundamental causation test. If the project was demonstrably successful, the insurer can be confident that the interruption of payments was the result of a covered
political risk. But suppose that a covered event occurs before the first payment is due? Will the insurer then be obliged to make that payment, and all subsequent payments required by the contract, until and unless the situation is remedied? The insured is thus in as good a position as if the project had been entirely successful, even though no one knows whether it would have been able to make a single payment from its own earnings. Does political risk insurance on such a project lead to a windfall? Does it create a moral hazard? What about business income coverage on a project that has just begun operations? Does this type of coverage in general require more skill in making financial projections than most investors (and insurers) have? In OPIC’s first business income coverage claim, it hired an accountant with industry expertise to assist in the calculation of compensation.

More generally, and more significantly, recent trends in expropriation cases demand that the underwriter understand the project documents and the financial and business aspects of the project. It is not enough to analyze the acceptability of country risk for the coverage or coverages requested.

Insurance contracts are standard, but deals are not. Are there assumptions in the insurance contract as to the terms of project agreements? Suppose, for example, that the contract assumes that a licensing fee will constitute a percentage of annual revenues and that the amount will be paid based on end-of-year financials. If the project documents fit that pattern, there may still be an issue as to the compensation payable if the foreign enterprise is expropriated and no end-of-year financials are prepared. That problem can probably be solved through negotiation, the process that solved the problem of the lack of an original purchase price for the mango crop. The problem is more pervasive if the actual contract departs radically from the assumptions underlying the insurance contract. Suppose that the fee is a sum certain due upon signature of the agreement but payable in annual installments, with interest. The insurer’s exposure would then be much higher than if fees could not exceed a small percentage of annual revenues. Coverage elections might reveal the incongruity between the insurance contract and the project agreement but only if several departments within the insurer were alert to the implications of contract terms.

In view of the possibility that a political risk insurance claim may constitute an exit strategy from a failed project, the underwriter must be alert for project risk factors. A project that is 100 percent debt financed on the basis of optimistic assumptions as to market
prices, demand, and the cost of inputs would raise a lender’s eyebrows. A political risk insurer who ignores the financial weakness of the project structure will be exposed to a claim based on any disappointed expectation for which the foreign government can conceivably be held responsible.

In too many international projects, the quality of project documentation is below what would be acceptable in a domestic transaction of the same order of magnitude. If the insurer accepts the deficiencies as inevitable in light of inadequacies of local law, the parties’ lack of sophistication, or the transactions costs entailed in clearing up the deficiencies, the contract can be issued without delay, but the deficiencies are unlikely to be remedied later to the benefit of the investor or the insurer. More likely, they will be highlighted as an excuse for adverse foreign government action.51

The potential problems are even more obvious when the project not only has financial weaknesses but is also the subject of political controversy. One response from the insurer is to mitigate known problems by special amendments to the insurance contract. When issuing coverage in circumstances in which there are unusual country risks or active disputes relating to the project, OPIC has attempted to manage these risks by negotiating special contract provisions to allocate those risks to the investor. A routine example would be lengthening the standard waiting period before an inconvertibility claim can be filed in order to recognize that, in the project country, delays are known to be longer than the standard period. When OPIC first began operating in the Russian Federation, the legal framework for foreign investment was in flux. A standard amendment for Russian projects established that issuance of insurance did not constitute assurance by OPIC of the validity of any agreement relating to the investment under Russian law.

There are limitations to risk mitigation by contract. As indicated by OPIC’s experience in recent Dabhol-related arbitration, the special risk allocation provision negotiated in the insurance contract may not be enforced, transforming the special contract into the standard contract that would not have been issued.52 Managing risk by special contract amendments is not impossible, however. In one case, OPIC agreed to issue coverage for a project that did not meet OPIC’s published underwriting guidelines for its contractor program, namely, that the project must have secure and adequate funding, usually from an international development or export credit agency. OPIC issued this coverage on the basis of unique amendments that were intended to create a “surrogate” to the underwriting guidelines by
requiring the insured to demonstrate that the foreign government had the foreign exchange to pay amounts due under contracts between the investor and parastatal companies. The investor was not paid, OPIC enforced the provisions and denied the investor’s claims, and the insured commenced arbitration. OPIC prevailed in two rounds of arbitration and some related litigation, but the dispute dragged on for about eight years, resulting in legal expenses that far surpassed any premium income and a diversion of staff resources and loss of goodwill that far outweighed any initial satisfaction at finding a way to provide coverage.

Managing risk by special contract amendments “worked,” but only in a narrow sense. In insurance as in other fields, there may be deals to walk away from. However, for a national or international agency, walking away from a project is especially hard, because these insurers do not evaluate projects solely based on underwriting criteria.

Lessons Learned from “Near Claims”

A “near claim” does not lead to a rigorous claim determination, but it focuses attention on a real scenario against which underwriting assumptions and contract provisions can be tested. OPIC insurance contracts require that the insured give OPIC notice of potential claims under any of the three coverages. A typical contract provision reads as follows:

Compulsory Notice: The Investor shall notify OPIC promptly if it has reason to believe that the Investor or the foreign enterprise will not be able to convert or transfer local currency during the waiting period. . . . The Investor shall notify OPIC promptly of any acts or threats to act in a manner which may come within the scope of the expropriation or political violence coverage . . . and shall keep OPIC informed as to all relevant developments.

In all cases, early notice expedites the overall claim process by affording an opportunity to clarify contractual requirements and responsibilities and focus fact-finding. If an insured eventually files a claim, the initial application for compensation is more likely to make the best case that the insured is entitled to compensation in the amount claimed than if the application is made without prior consultation.
Notice is most important when the problem is project specific and
the investor is the best (or only) source of information. No investor
gave notice of the Gulf War, and only some investors gave notice of
the deteriorating situation in Argentina and Venezuela. Certain
investors seem to give notice at the first sign of any difficulty,
whereas others assume that OPIC staff at least read the newspapers.
Lack of notice would certainly be material if it prevented OPIC
from making an effort to avert a claim or obtain contemporaneous
evidence as to the substance of a claim.\textsuperscript{55}

Having received notice, OPIC may be able to intervene with the
foreign government to avert an inconvertibility claim or expropria-
tion claim. If an inconvertibility claim is inevitable, early notice at
least affords an opportunity to determine what salvage mechanisms
may be available and ensure that local currency is transferred to
OPIC and in line for conversion through those mechanisms as soon
as possible. In the case of a potential expropriation claim, early
notice may allow OPIC to act as an intermediary and resolve an
investment dispute or support a settlement.\textsuperscript{56}

In one case, an OPIC–insured contractor working on a major port
project in Central America became involved in a dispute with the port
authority and project engineer. The contractor submitted its dispute
to international arbitration and prevailed. The foreign government
publicly refused to honor the award. There was some suggestion that
the contractor should have the award “confirmed” by local courts.
Instinctively, the investor resisted, both because of reservations about
the independence of the judiciary and because there were some tech-
nical flaws in the award. For more than a year, OPIC worked with the
investor, the foreign government, and the numerous other stake-
holders in the project to achieve a settlement. The final settlement was
made possible, in part, by OPIC’s willingness to make an advance
payment to the investor and to allow the foreign government to make
partial payment in local currency (which OPIC accepted, as if in set-
tlement of an inconvertibility claim, while paying the dollar equiva-
 lent to the investor).\textsuperscript{57}

In another case, an OPIC–insured contractor had a series of dis-
putes with a foreign government agency for which the contractor
was building a major irrigation project. The multistage dispute res-
olution procedure predictably protracted the dispute resolution
process. Several disputes were over the contractor’s entitlement to
extensions of time. Without resolution of the contractor’s requests
for extensions of time, the contractor was under pressure to commit
additional equipment to the project (and make additional investments) to avoid possible penalties. The government agency granted the requests only after project completion, when the contractor’s claims for damages exceeded the project budget. The contractor had established a record of success once the dispute resolution procedure reached the level of international arbitration. Reluctant to risk a major defeat, the foreign government brought an injunction in its courts against further resort to international arbitration. This maneuver alone could have led to an OPIC claim. Working with the American Embassy, OPIC eventually persuaded the foreign government to vacate the injunction and honor the arbitration clause, averting a claim for refusing to comply with the procedure. The next challenge came when the arbitrators issued an award in favor of the contractor that heavily penalized the foreign government agency for its treatment of the contractor. The amount of the award was far in excess of the maximum amount payable under the contractor’s OPIC insurance ($8.1 million). In multiparty negotiations, OPIC was able to achieve a settlement funded by a combination of the foreign government’s own resources (committed with the approval of the IMF), amounts of U.S. foreign assistance that were obligated but unlikely to be used for other projects in the country, and (the largest amount) funds borrowed by the foreign government on the strength of an OPIC guaranty (which is backed by the full faith and credit of the United States). The contractor received $50 million, less than the $64.3 million (including interest) due under the award. The foreign government has made payments on the loan, and OPIC has been collecting guaranty fees on the declining balance of its contribution to the settlement.58

In both these cases, before committing itself to supporting a settlement, OPIC had been given ample notice of the prospective claim and enough information to be satisfied that any claim would be valid. The settlements were in the mutual interest of all concerned, because they achieved more than a simple OPIC claim payment could have, including payments to the investor that more closely approximated full compensation and settlement of third-party claims associated with the project.

More recently, OPIC has engaged in “advocacy” efforts on behalf of insured investors, intervening with foreign governments to resolve investment disputes even in situations in which OPIC would not recognize a valid claim and the investor disclaims any intent to make one, at least initially. Working alone or with other
U.S. government agencies, OPIC has succeeded in resolving some investment disputes and averting potential claims (valid or not) through these advocacy efforts.59

The perils of advocacy include plunging into an unfamiliar situation, making a premature judgment on the merits, winding up on the “wrong” side of the dispute, and, for any or all of these reasons, undermining the credibility that would have made OPIC a useful intermediary. There is also a risk of embarrassment by becoming involved without as complete an understanding of the facts and legal issues as in the two cases described above. One investor, for example, complained that the foreign government’s tariff treatment of its product was irrational, perhaps “corrupt.” Fortunately, before asking the U.S. ambassador to make a demarche along those lines, OPIC learned that the foreign government had adopted the U.S. tariff schedule. The tariff treatment may have been surprising, but it was certainly not corrupt. There is also the risk of blame for failure. One investor even cited OPIC’s advocacy efforts as evidence of bad faith—”doing everything possible to avoid paying a valid claim.”

Expectations in near-claim situations should be delineated clearly. Finally, there is the risk that the insured will portray advocacy efforts as an affirmative determination on an eventual claim, without giving the insurer the benefit of full information and without complying with contractual requirements.

Some near claims have been resolved almost by coincidence. There are stakeholders in projects other than OPIC’s insured and the foreign investor, and those other parties’ assertions of interest can help or hinder OPIC’s efforts to resolve a claim. In one case, an investment dispute was resolved primarily because the purchasers of the project output brought pressure on the foreign government to get the project back in production. The dispute arose between a Canadian mining company and the host government. OPIC insured a U.S. project lender, not a direct party to the dispute. U.S. firms whose plants were designed to use the ore from the mine would have had to shut down or retool unless the mine resumed production. Their influence led to a speedy resolution.60

In other cases, the legitimate interests of other parties have precipitated disputes or complicated their resolution. Foreign governments have taken action adverse to foreign investors in keeping with a program of economic reform or in response to a country austerity program imposed by an international financial institution or providers of bilateral assistance, including the U.S. government. In those cases, prospects for relief for a particular investor are remote,
and OPIC’s prospects of recovery upon payment of a claim may be diminished.

In one case, a government was urged to clean up the balance sheet of its parastatal companies in the mining sector as a prelude to their privatization. Unfortunately, the foreign government achieved the cleanup by repudiating the parastatals’ existing debt, leading to claims against various export credit agencies and OPIC.\(^61\) In the recent Asian debt crisis, OPIC paid the largest claim in its history ($217.5 million) when the Indonesian government set aside major contracts in the power sector and then attempted to thwart the contractual dispute resolution process.\(^62\) OPIC paid the claim and eventually obtained an agreement for compensation from the government of Indonesia, which that government has performed.\(^63\) However, along the way OPIC was under some pressure to consider the “big picture” of debt crisis resolution. Ultimately, OPIC’s view that expropriation is a wrongful act and compensation due for it should not be treated on a par with other unpaid debts prevailed.

When foreign government actions that represent a response to crises that cannot be ignored or an effort to enact reforms that are obviously needed result in injuries to investors, the resulting claims are particularly difficult, especially when the foreign government bases its actions on neutral, authoritative advice or the actions are a condition precedent to essential assistance from the sources of that advice. In a recent OPIC claim, the foreign government had opened its markets to imports and competition by lowering tariff barriers and eliminating parastatal monopolies on imports and marketing.\(^64\) Undeniably, these were good policy decisions. However, a foreign investor had built a plant designed to serve a protected domestic market, which it had done for many years on the basis of investment agreements with the government that guaranteed a certain profit margin. In the era of state monopolies, the margin was easy to establish and maintain by protective tariffs and monopoly prices. In an otherwise free market, the investor would have required direct subsidies, which would have been unacceptable to international financial institutions and aid donors and which the foreign government could not afford. The investor’s position was that the foreign government should honor the investment agreement or pay compensation for breach. The government could not afford to pay compensation to all investors whose agreements were undermined by reform and was reluctant to set any precedent for doing so.

OPIC insured only the expansion, which was undertaken at foreign government encouragement just as the government was
removing the policy underpinning for the project. These facts led OPIC to pay a claim, but only for the expansion. The investor was left free to resolve its dispute over the basic project.

Lessons Learned from Claims Denied

OPIC’s claim process gives the insured every opportunity to make its best case. The application for compensation is not a completed standard form but a series of interactions in which the insured answers questions posed by OPIC and supports the answers with additional documents. An application for compensation “shall demonstrate the Investor’s rights to compensation in the amount claimed. The Investor shall provide such additional information as OPIC may reasonably required to evaluate the application.” The application should address three categories of issues with reference to facts and contract provisions: whether the actions or events that are the basis of the claim are within the scope of coverage, the amount of compensation payable, and the investor’s compliance with its duties under the insurance contract.

If OPIC’s determination is adverse, OPIC provides the insured an opportunity to review its reasoned decisional document in draft and comment on it before the determination becomes final. OPIC has been persuaded to change its position based on comments made on a draft determination.

Throughout the claims process, the insurer must remember that the process itself is important. One investor was rumored to be dissatisfied with OPIC’s claim handling. Whenever OPIC prepared for meetings to discuss the dissatisfaction (which was never explained with any specificity), OPIC reviewed the investor’s claims history only to find that, in the aggregate, the investor had received more compensation than it had claimed and had never had a claim denied. Clearly, then, there are other possible sources of dissatisfaction, such as the quantum of proof required to establish a claim, the length of time for reaching a determination, and the terms of assignment or settlement.

If an investor who has been compensated in full can find fault with the claim process, one whose claim has been denied with finality may have even stronger feelings. Having face-to-face meetings may reduce the level of confrontation, build some rapport, and, at worst, afford an opportunity to assess the credibility of the insured’s representatives and witnesses. OPIC has statutory authority to settle claims through compromise, and it has done so in exceptional cases.
In determining an insurance claim, the most fundamental issue is whether the events or actions that gave rise to the claim were within the scope of coverage as defined by the insurance contract. Disagreements as to coverage hold lessons for the insurer in drafting and negotiating its contracts. Compared with other project documents, an insurance contract is short and simple, but political risk insurance form contracts have been drafted and redrafted by a small number of issuers, largely working apart from both the insurance bar and the project finance lawyers who are most likely negotiating on behalf of the investor. In a controversy, this can lead to genuine surprises all around. Issuers know what their contracts and amendments are supposed to mean, but that does not guarantee comprehension on the part of others or foreclose the possibility of contrived claims of ambiguity. There is no easy solution. Issuers cannot refuse to cover projects that do not conform to the assumptions of their standard contracts nor can insurance contracts be custom drafted in their entirety for every project.

OPIC developed amendments to its standard contract as the result of a proposal made by counsel for an investor that there should be an exception to a standard exclusion from coverage in certain projects. The issue is that the standard exclusion from expropriation coverage for acts of the foreign government exercising commercial (as opposed to governmental) functions with respect to the project might render coverage meaningless on a major infrastructure project, in which the foreign government is typically involved in numerous “commercial” capacities. To provide meaningful expropriation coverage, the insured is given an opportunity to make its case to OPIC on its expropriation claim if it prevails in arbitration according to the dispute resolution provision of the underlying contract, thereby sorting out the commercial issues. Relying on the dispute resolution procedure agreed on by the insured and the foreign government to decide claim-related issues, and even insuring the dispute resolution process, were familiar concepts derived from OPIC’s program for contractors and exporters.

The infrastructure amendments represent an ingenious but complicated solution to a problem that only relatively sophisticated counsel and investors would have identified in the first place. Would others, whether investors or arbitrators, understand what the infrastructure amendments are intended to achieve and why and how they were to do so?

Contracts that are unambiguous should stand alone, but arbitrators seem prone to examining extraneous evidence as to intent
and understanding. With that in mind, the insurer cannot take mutual understanding for granted even when the corporate investor has dealt with the insurer frequently over a long period of time. A corporation’s knowledge is, after all, a legal fiction. A particular project team may have no understanding at all of the insurance arrangements that the corporation has made over the past 20 years. Moreover, the insurer may be imputing knowledge to an entire conglomerate corporate empire, although imputing knowledge to affiliates stretches even the legal fiction and actual knowledge resides, or used to reside, with a few individuals in only a few boxes in the organizational chart. Regardless of the general sophistication and resources of the investor, it is in the insurer’s interest to confirm that the particular project team representing the investor actually understands key concepts of the insurance contract.

The most troublesome amendments are those that restrict the scope of coverage. If such amendments cannot be understood without an above-average understanding of the basic contract form, the insurer, as drafter, is especially vulnerable to the boilerplate argument that the amendments defeat the insured’s reasonable expectations. The same is true when contract amendments constitute an attempt to cram a conceptual square peg into a contractual round hole by redefining contract terms to fit an unusual project structure into the standard insurance contract.

At some point, the insurer may tire of covering contract-based investments on a policy form intended for equity investments and instead develop specific forms for various nonequity investments. In principle, it should be possible to draft insurance contracts that cover the full range of investments that OPIC has statutory authority to insure and that are recognized as investments under investment protection treaties (“every sort of investment”). OPIC’s practical experience has been that there can be a tendency to carry through concepts from the equity form that lack true equivalents with respect to other forms of investment (e.g., “book value”). In addition, isolation of commercial risk can be more difficult.

The insurer should set expectations, identify and address dispositive issues as early as possible, and make clear that political risk insurance claims cannot be resolved as quickly or simply as the personal insurance claims with which investors are familiar as consumers. MIGA and OPIC will always be slower than an automobile insurer. The claims process may be rigorous, but it should not be self-defeating. Adherence to standard procedures and protection of the insurer’s interests as subrogee has to be balanced against the
costs of delay for both the insured and the insurer. In an inconvertibility claim, for example, the risk of devaluation has shifted to the insurer, and so time spent polishing internal memos and even the public determination can result directly in lost recoveries. One unfortunate phrase in an internal document can become the focus of an arbitration proceeding.

Notwithstanding the sophistication of insured investors and the specialized nature of political risk insurance in a dispute, the insurer may be faced with the standard arguments that any consumer could bring against any insurer (e.g., the contract must be construed against the drafter, the contract must meet the reasonable expectations of the insured). The insurer may also be held to consumer law standards of conduct in the claims process. With all this in mind, it is important that the insurer give fair weight to the insured’s arguments, be realistic about the impact of any errors made by the insurer, and anticipate a third party’s reaction to the arguments made by the insured and insurer.

Lessons from Claims-Related Arbitrations

Disputes arising from OPIC insurance contracts have been resolved by arbitration in Washington, DC, pursuant to the American Arbitration Association (AAA) commercial rules. In recent cases, however, the AAA has assigned OPIC’s arbitrations under the commercial rules to the AAA’s International Centre for Dispute Resolution, in keeping with the international nature of the projects and the issues that arise in political risk insurance claims.

Denial of a claim is the dispute that most likely gives rise to controversy, but the arbitration clause applies to any dispute arising from the insurance contract. OPIC has had one arbitration case filed against it over termination of an insurance contract, which it settled through negotiation. Conceivably, a dispute could arise concerning the manner in which a claim is handled or over OPIC’s alleged delay in reaching a determination. The insured could also conclude that its arguments are not convincing OPIC and might decide to try them out on a panel of arbitrators instead, before OPIC reaches even a preliminary determination.

OPIC’s experience in arbitration has been mixed. After each particularly frustrating experience, OPIC has reexamined its arbitration clause, researched alternative rules, and reconsidered whether litigation might be preferable. In the end, OPIC has left the dispute resolution provision substantially unchanged.
This is not the place for a general restatement of the pros and cons of arbitration versus litigation. From OPIC’s perspective, the primary advantage of arbitration is that it affords an opportunity to select a decision maker (or panel of decision makers) whose background and experience should be helpful in understanding the issues and reaching the right result. Sometimes the challenge is predicting what the key issues will be and deciding what background or experience (insurance, international business, international law, project finance, sectoral, and regional expertise) will be most helpful. OPIC’s experience with arbitrator selection certainly includes some unhappy surprises, but in litigation there would have been no selection opportunity at all.

The biggest drawback of arbitration is that an ad hoc panel can reach a binding determination that is not subject to review to the same extent as a court decision and (under the AAA commercial rules) need not be a reasoned decision. The early arbitrations over OPIC claims nevertheless resulted in detailed, well-reasoned awards that contributed to the development of the international law of foreign investment and provided OPIC with guidance. The Revere case, for example, is widely cited for the proposition that investment agreements are “internationalized.” It may also have led OPIC to clarify contract provisions concerning adjustment of financial statements (revaluing used equipment, undoing transfer prices that are not at arm’s length, etc.), because, although the arbitral award and related court decisions concluded that OPIC’s contract provisions were unambiguous, it became clear that the provisions could have been better written.

The Anaconda claim was contentious principally because the investor had all coverage on standby (at significantly reduced premium rates) when the foreign government took its first steps toward nationalization. The U.S. Agency for International Development (USAID), and later OPIC, refused to permit the investor to activate all its coverage once the process of nationalization had begun. Subsequent contract forms required an investor to be insured for the full amount of the insured investment at risk. The current standard contract allows the investor to elect a coverage ceiling above the active coverage amount but pay premiums only on the active amount. It also imposes a surcharge for underinsurance.

The ITT case is notorious because of the allegations that the investor provoked the expropriation by participating in efforts to overthrow the foreign government. OPIC’s insurance contract contained no explicit excuse for refusing payment under such
circumstances, and the arbitrators ruled in favor of the investor. More recently, insureds have resisted issuance of reasoned awards, sometimes out of concern that a reasoned award might be more likely to be subject to challenges than a bare monetary award, sometimes out of reluctance to pay the arbitrators' hourly rates while they draft a reasoned award. Some recent awards therefore leave OPIC (and others) guessing as to the lessons that should be learned and the changes that should be made in light of a claims-related controversy. An adverse decision containing no reasoning or flimsy reasoning (e.g., “under all the circumstances”) can be frustrating, but the recent lengthy reasoned award in Dabhol seems to have left the insurance industry in as much confusion as if it had been accompanied by no explanation at all.

OPIC's Experience in Achieving Recoveries on Claims Paid

As of September 30, 2004, OPIC's total recoveries on insurance claims amounted to $740 million on total claim settlements of $915 million, a recovery rate of 81 percent. OPIC's losses on claim settlements (in total $174.7 million) were experienced primarily on expropriation claims ($134.9 million) and political violence claims ($31.5 million). Expropriation claims account for the highest percentage of both claim settlement amounts (84 percent) and recoveries (86 percent). Political violence claims have represented the lowest share of both claim payments (4 percent) and recoveries (0 percent). Inconvertibility claims have been the most numerous (62 percent), but they account for only 12 percent of OPIC claim settlement amounts and 14 percent of recoveries.

OPIC’s historical overall recovery rate on claim payments has exceeded 90 percent. The lower rate as of September 30, 2004, is almost entirely attributable to unresolved claims against the government of India arising out of the $112.1 million in expropriation claims OPIC paid to investors in the Dabhol power project.

Recovery has been achieved primarily by relying on the intergovernmental agreements that are statutorily required for the operation of OPIC’s insurance and reinsurance programs in any country or area. With respect to inconvertibility claims, these agreements permit the transfer to OPIC of local currency accepted upon payment of dollars to the insured investor. Typically, OPIC’s local currency holdings are then purchased by other U.S. government agencies to meet their local currency needs. OPIC
bears the risk of devaluation of its local currency holdings until they are purchased, and purchases are made at the best rates that other agencies could obtain.

Expropriation claims have generally led to intergovernmental negotiations and deferred payment arrangements, which foreign governments have consistently honored. For example, OPIC recently achieved a settlement with the government of Indonesia with respect to the MidAmerican claim. The intergovernmental agreements provide for international arbitration, but until the Dabhol-related claims in India, OPIC had succeeded in achieving recoveries without resort to the formal arbitration procedure provided in these agreements. In the case of India, for the first time, the U.S. government has had to request arbitration under the intergovernmental agreement that provides for the operation of OPIC’s programs there.

Conclusion

Ideally, consciousness of potential claims issues should pervade all the insurer’s processes, including analyzing the project, underwriting the associated risks, and drafting and administering the contract. This awareness should persist throughout the term of the contract, even without any notice of claims. Such consistency is possible only if underwriters are familiar with the insurer’s specific claims experience, as well as general principles of risk management; if contracts are drafted and form contracts revised based on lessons learned from claims experience; and if contract administrators are alert to warnings of potential claims and bring anomalous coverage elections to the attention of others within the organization. These are high expectations, but by striving to achieve them, an insurer can at least reduce the element of surprise over coverage and compensation issues should a claim arise.
Annex A: Insurance Claims Experience of OPIC and Its Predecessor Agency

OPIC provides political risk insurance and project financing for U.S. investors in developing nations and economies in transition. Since 1971 it has made 279 insurance claim settlements, totaling $914.7 million. These settlements have been structured either as cash settlements to investors ($558.1 million) or as OPIC guaranties of host government obligations or other similar arrangements ($688.1 million). In accordance with those arrangements, OPIC had paid $129.9 million in addition to the cash settlements, for a total of $356.0 million as of September 30, 2004.

OPIC recoveries in respect of cash paid out on claims total $294.8 million (without regard to reinsurance reimbursements). Additional recoveries, particularly with respect to recent claim payments, are anticipated.

OPIC has denied 25 claims under the insurance programs, 12 of which have been submitted to arbitration by the investors. As of September 30, 2004, pending claims totaled $50.7 million.

Before OPIC was established, its programs were administered by USAID. From 1966 to 1970, USAID paid $3.5 million in settlement of eight claims. It denied eight claims, one of which was submitted to arbitration by the investor.

For additional information about OPIC insurance claims or a copy of the year-end cumulative history of claims, please contact Susan Fribush, Claims Assistant, by telephone (202-336-8437), email (Sfrib@opic.gov), or fax (202-218-0151).
Annex B: Tabular Summary of OPIC’s Cumulative Claims History

**Claims Resolved by Cash Settlements and Guaranties—FY66 Through FY04**

**Types of Claim**
- A—Inconvertibility
- B—Expropriation
- C—War Damage
- F—Civil Strife

<table>
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<tr>
<th>Investor</th>
<th>Country</th>
<th>Type of Claim</th>
<th>Industry</th>
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(continued)
### Types of Claim

A—Inconvertibility  
B—Expropriation  
C—War Damage  
F—Civil Strife

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**FY74**

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**TOTAL**

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<th>Cash Amount</th>
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## Claims Resolved by Cash Settlements and Guaranties—FY66 Through FY04 (continued)

### Types of Claim
- **A**—Inconvertibility
- **B**—Expropriation
- **C**—War Damage
- **F**—Civil Strife

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<th>Investor</th>
<th>Country</th>
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<th>Industry</th>
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### FY78
- **Bank of America/ Petrodow II**
  - Chile, A, Banking: $868,642, $0, $868,642
- **Bank of America/ Arauco III**
  - Chile, A, Banking: $4,397,727, $0, $4,397,727
- **Chase Int’l Invest. Corp.**
  - Zaire, A, Textiles: $219,038, $219,038, $0
- **Union Carbide**
  - Ghana, A, Batteries: $250,673, $250,673, $0
- **Cabot Corp.**
  - Colombia, A, C. Black: $215,558, $215,558, $0
<table>
<thead>
<tr>
<th>Company</th>
<th>Country</th>
<th>Sector</th>
<th>FY79 Quantity</th>
<th>FY79 Value</th>
<th>FY79 Changes</th>
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<tbody>
<tr>
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### FY79

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<th>Sector</th>
<th>FY79 Quantity</th>
<th>FY79 Value</th>
<th>FY79 Changes</th>
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<td>Indonesia</td>
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<td>Peru</td>
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<td>Chad</td>
<td>B Gum Arabic</td>
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(continued)
### Claims Resolved by Cash Settlements and Guaranties—FY66 Through FY04 (continued)

#### Types of Claim
- **A**—Inconvertibility
- **B**—Expropriation
- **C**—War Damage
- **F**—Civil Strife

<table>
<thead>
<tr>
<th>Investor</th>
<th>Country</th>
<th>Type of Claim</th>
<th>Industry</th>
<th>Settlement Amount</th>
<th>Cash Amount</th>
<th>Guaranty Amount</th>
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<td>Sudan</td>
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<td>Farming</td>
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<td>Morton-Norwich</td>
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**FY81**

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(continued)
### Claims Resolved by Cash Settlements and Guaranties—FY66 Through FY04 (continued)

#### Types of Claim
- **A**—Inconvertibility
- **B**—Expropriation
- **C**—War Damage
- **F**—Civil Strife

<table>
<thead>
<tr>
<th>Investor</th>
<th>Country</th>
<th>Type of Claim</th>
<th>Industry</th>
<th>Settlement Amount</th>
<th>Cash Amount</th>
<th>Guaranty Amount</th>
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<td>Const.</td>
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#### FY82
- **Union Carbide**
  - Ghana: A Batteries, Settlement Amount: $75,600, Cash Amount: $75,600, Guaranty Amount: $0
- **Gillette Corp.**
  - Iran: B Razors, Settlement Amount: $164,853, Cash Amount: $164,853, Guaranty Amount: $0
- **Union Carbide**
  - Sudan: A Batteries, Settlement Amount: $1,403,267, Cash Amount: $1,403,267, Guaranty Amount: $0
- **Morrison-Knudsen**
- **Intercontinental Hotels**
  - Iran: B Hotels, Settlement Amount: $1,754,832, Cash Amount: $1,754,832, Guaranty Amount: $0
- **Carrier Corp.**
  - Iran: B Air Cond., Settlement Amount: $2,395,000, Cash Amount: $2,395,000, Guaranty Amount: $0
- **CPC Europe Group**
  - Iran: B Glucose, Settlement Amount: $236,000, Cash Amount: $236,000, Guaranty Amount: $0
- **Chase Int'l Invest. Corp.**
  - Zaire: A Textiles, Settlement Amount: $84,090, Cash Amount: $84,090, Guaranty Amount: $0
- **General Mills**
- **Foremost McKesson**
  - Iran: B Dairy, Settlement Amount: $15,000, Cash Amount: $15,000, Guaranty Amount: $0
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<thead>
<tr>
<th>Company</th>
<th>Country</th>
<th>Category</th>
<th>FY82</th>
<th>FY83</th>
<th>Beginning Balance</th>
</tr>
</thead>
<tbody>
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<td>Kimberly Clark</td>
<td>El Salvador</td>
<td>Paper</td>
<td>$417,949</td>
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<td>Equator Bank</td>
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**FY83**

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<th>FY83</th>
<th>Beginning Balance</th>
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### Types of Claim

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**B**—Expropriation  
**C**—War Damage  
**F**—Civil Strife

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**FY86**

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## Claims Resolved by Cash Settlements and Guaranties—FY66 Through FY04 (continued)

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**FY91**
- Keene Industries, Liberia: F, Rubber, $2,429,352
- Tea Importers, Rwanda: F, Tea, $6,169
- Kimberly Clark, Panama: F, Paper, $55,911
- Zachary & Dillingham, Sri Lanka: B, Const., $30,000,000

**TOTAL**
- $32,491,432
- $2,491,432
- $30,000,000

**FY92**
- Carter Day, Egypt: B, Seed, $43,750
- Continental Grain, Brazil: A, Grain, $2,009,894
- Henry R. Jahn, Syria: B, Farming, $20,371
- Hoyt & Worthen, Haiti: F, Tanning, $155,897

**TOTAL**
- $2,229,912
- $2,229,912
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(continued)
## Types of Claim

- **A**—Inconvertibility
- **B**—Expropriation
- **C**—War Damage
- **F**—Civil Strife

### Claims Resolved by Cash Settlements and Guaranties—FY66 Through FY04 (continued)

<table>
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<tr>
<th>Investor</th>
<th>Country</th>
<th>Type of Claim</th>
<th>Industry</th>
<th>Settlement Amount</th>
<th>Cash Amount</th>
<th>Guaranty Amount</th>
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(continued)
### Types of Claim

**A**—Inconvertibility

**B**—Expropriation

**C**—War Damage

**F**—Civil Strife

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<th>Country</th>
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<th>Settlement Amount</th>
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a. For these claims, cash was subsequently paid under the guaranty or indemnity, hence there was no corresponding increase in the overall settlement amount.
b. Claims for failure to adhere to dispute resolution procedure or honor arbitral award.
c. Claims for Chase Manhattan and Bank of America in Vietnam were settled not by guaranties but by indemnity agreements for $8,000,000 and $6,000,000, respectively.
d. Without determining that expropriatory action had occurred, OPIC and the investor agreed on a negotiated sum in settlement of the claim, avoiding a contest over complex and ambiguous legal and factual issues.
e. Claim for wrongful calling of an on-demand guaranty.
f. Pending completion of the investor’s application for compensation, OPIC agreed to make a $2,000,000 provisional payment, $1,500,000 of which was paid. In 1998, the investor established its claim for compensation up to the contract limit, and OPIC paid an additional $14,204,500.
g. Standard Fruit filed its expropriation claim with OPIC in 1983, seeking compensation in the amount of $3,000,000 (the policy limit). As means of settling the claim without prejudicing the investor’s position in pending litigation with the foreign government, OPIC made an advance payment of $2,000,000, subject to a confidentiality agreement and with the understanding that Standard Fruit could later present arguments that it should be paid the remaining $1,000,000, should the litigation produce additional relevant evidence. The investor and foreign government eventually settled their claims and counterclaims. OPIC denied the investor’s request for an additional payment. OPIC and the investor agreed in 1998 on a mutually acceptable public statement about the claim, and the advance payment then became final and disclosable.
h. The settlement amount includes a provisional payment in the amount of $4,372,492 made on November 27, 2002, which was made final by the terms of the settlement.
i. These three payments were all in settlement of the claim of Offshore Power Production CV, an affiliate of Enron Corp.
Notes

26. OPIC maintains public information files on its claim determinations. Access to these files may be arranged by appointment pursuant to 22 C.F.R. Part 706. Claim determinations made since 1996 are available through OPIC’s website. The current version of OPIC’s cumulative claims history is provided in annex A to this paper.

27. Immediately before OPIC was established, the U.S. Agency for International Development administered the U.S. government’s political risk insurance program. From 1966 to 1970, that program paid $3.5 million in settlement of eight claims and denied eight claims, one of which was submitted to arbitration. Although the U.S. government’s political risk insurance program dates back to the Marshall Plan, the first claim arose only in 1966.

28. See the tabular summary of OPIC’s cumulative claims history presented in annex A to this paper.


30. OPIC insurance may be issued only to “eligible investors” (see 22 U.S.C. § 2194(a)). The term “eligible investor” is defined in 22 U.S.C. § 2198(c). In general, eligibility is determined by reference to ultimate beneficial ownership by U.S. citizens, so transnational corporate acquisitions have reduced the pool of prospective eligible investors. An insured investor is generally required to maintain eligibility throughout the term of the insurance contract. (See, e.g., OPIC Form 234 KGT 12–85 [Revised 12/03] NS, [“OPIC Standard Contract”].) The form contract may be obtained from OPIC upon request.

31. OPIC projects are subject to an array of eligibility requirements relating to OPIC’s status as a U.S. government development agency. (See, e.g., 22 U.S.C. § 2191, and the OPIC Program Handbook, 1–2 [hereafter “Program Handbook”].) These criteria have reduced the risk of OPIC involvement in some categories of vulnerable projects, such as projects entailing the passive ownership of large tracts of land. See the U.S. Department of State’s August 2004 background note on Costa Rica, available at http://www.state.gov/r/ia/98246.htm, which mentions the occurrences of land invasions from squatters targeting foreign landowners.


33. “Because Iran was considered politically stable by most U.S. investors, OPIC’s exposure in that country was relatively low, and maximum liability as of September 30, 1979, was $63.9 million.” OPIC Annual Report 37 (1979). Ultimately, OPIC paid 15 claims in Iran totaling almost $16 million.
34. The Philippines accounts for the largest number of OPIC claims (28), but more than half of the claim payments were to two investors, Kimberly Clark (12) and Armco (7). The Democratic Republic of Congo (formerly Zaire) takes second place with 27 claims, but there too, more than half the claims were paid to two investors, Goodyear Tire & Rubber (13) and Chase International Investment Corporation (6). In Ghana OPIC paid 20 claims, all to two investors, Firestone Tire & Rubber (14) and Union Carbide (6).

35. The timing of the claims also has to be considered. OPIC’s experience in Chile (25 claims under all three coverages, with total payments of $316 million) probably does reflect Chile’s situation, but only in the 1970s. The most recent claims were two inconvertibility claims paid in 1977. Such dated claims experience is not relevant to any current underwriting analysis.


37. OPIC’s average inconvertibility claim payment has been $651,163. The amount of the First Trust of New York claim was $9.8 million.

38. OPIC’s insurance, reinsurance, and loan guaranty programs are available only in countries and areas with which the United States has an agreement for their operation. See 22 U.S.C. § 2197(a). These agreements provide that OPIC may accept and use local currency transferred to OPIC in connection with a claim. See, for example, the Investment Incentive Agreement between the Government of the United States of America and the Government of the Republic of Nicaragua (July 20, 2004) (hereafter “Nicaragua Investment Agreement”). The provisions of the standard agreement also satisfy the requirement of 22 U.S.C. § 2197(b) that suitable arrangements exist for protecting OPIC’s interests concerning, for example, the use of currency on account of which the insurance payment is made. The typical use has been to satisfy local currency needs of the U.S. government.


40. See Copson, Raymond W. 2001. CRS Report for Congress: Zimbabwe Backgrounder 4, on the Zimbabwe government’s plan to develop an economic structural adjustment program that would strengthen the domestic economy. The government failed to initiate the program successfully, leading to serious economic difficulties. Id. at 15.

41. Is “the IMF made me do it” a valid excuse for actions that might otherwise be deemed expropriation? Should a political risk insurer exclude actions having such motivation from coverage?

42. “OPIC shall pay compensation . . . in the amount of . . . the lowest of (1) the original cost; (2) fair market value; or (3) the reasonable cost of repair.” OPIC Standard Contract, § 7.01(a).


44. See claim of Haitian Tropical Management, Haiti (1993).

45. See three claims of Hoyt & Worthen, Haiti (1989–95).
47. See five claims of Sector Capital Corporation, Colombia (2002–3).
48. See claim of Sector Resources (2002).
49. Id.
55. In situations in which multiple claims are anticipated, OPIC has monitored its entire portfolio for potential claims on its own initiative. It did so in the Middle East during the 1991 Gulf War, when political violence claims were a possibility throughout the region; in Argentina, where the financial crises and emergency legislation created concerns of possible inconvertibility and expropriation claims; and, for similar reasons, in Venezuela. OPIC paid no claims as a result of the Gulf War and to date has paid no inconvertibility claims in Argentina and Venezuela. OPIC does not keep statistics on all categories of near claims. It is safe to say that a great many claims matters never get beyond the stage of monitoring or notice because a final claims determination becomes unnecessary, through any of the processes described here. OPIC does keep records on claims that investors have made and then withdrawn with prejudice. Since 1971, 46 claims have been withdrawn, because the underlying dispute was resolved, the investor obtained compensation elsewhere, or the investor acknowledged the claim’s lack of merit.
56. In the case of political violence claims, the practical effect of notice is to give OPIC an opportunity to begin understanding the situation at its earliest stages. The prospects of claim avoidance and recovery are remote, compared with the prospects of cases’ inconvertibility and expropriation claims. As of September 30, 2003, OPIC’s only recovery on a political violence claim was under a unique contract that provided compensation for income streams interrupted by political violence, subject to repayment of compensation once normal financial flows were restored.
59. The president’s letter in OPIC’s 1998 Annual Report highlighted OPIC’s advocacy program. The 1999 Annual Report gave an example of
OPIC’s successful advocacy on behalf of Ellicott Machine Corporation, which had OPIC insurance against the wrongful calling of an on-demand guaranty. The foreign government agency with whom the investor was dealing refused to release the guaranty, thereby requiring the investor to extend it, paying a fee and prolonging its financial exposure to the issuer of the guaranty. After three years of negotiation, OPIC succeeded in getting the guaranty released.

60. The U.S. firms lobbied the White House, which encouraged the foreign government to resolve the dispute. See Walde, Thomas W. 1 Transnational Dispute Management 1 (Feb. 2004), available at http://www.transnational-dispute-management.com/samples/freearticles/tv1-1-article_49.htm#_ftnref33.

61. This was the dispute that led to the Green Mining (Guyana) claims.


64. See claim of Joseph Companies, Jamaica (1999).

65. See “How to Present an OPIC Insurance Claim Effectively” (available from OPIC upon request).

66. OPIC Standard Contract § 8.01.


68. See OPIC Standard Contract, § 4.03(b).


70. Title IV of the Foreign Assistance Act of 1961 (P.L. 87–195 as amended) constitutes OPIC’s corporate charter. It includes definitions for use in relation to OPIC programs, including the following definition of investment: “the term ‘investment’ includes any contribution or commitment of funds, commodities, services, patents, processes, or techniques, in the form of (1) a loan or loans to any approved project; (2) the purchase of a share of ownership in any such project; (3) participation in royalties, earnings, or profits of any such project; and (4) the furnishing of commodities or services pursuant to a lease or other contract.” 22 U.S.C. §2198.

71. See, for example, the Treaty between the Government of the United States of America and the Government of the State of Bahrain Concerning the Encouragement and Reciprocal Protection of Investment (September 29, 1999).

72. OPIC insurance contracts establish the exchange rate at which compensation will be paid as of a date that precedes OPIC’s receipt of a completed application. If the investor files its completed claim application with OPIC on the first possible date, the rate at which compensation is payable should be the rate that was in effect on the date when
the investor applied to convert local currency through the normal channels. See OPIC Standard Contract § 3.01.


74. OPIC Standard Contract § 8.05.

75. The AAA Supplementary Procedures for International Commercial Arbitration then apply, unless the parties advise otherwise.

76. Press release, OPIC and Freeport-McMoRan Copper & Gold, Settlement Reached between Freeport-McMoRan Copper & Gold and Overseas Private Investment Corporation (April 19, 1996).


78. Some OPIC contract forms refer to the AAA international commercial rules.


80. See *In the Matter of Revere Copper and Brass, Inc. and Overseas Private Inv. Corp.*, reprinted in 17 I.L.M. 1321 (1978). See also Brand, Ronald A. Sovereignty: The State, the Individual, and the International Legal System in the Twenty First Century. 25 *Hastings International and Comparative Law Review* 279, 291 (2002). Brand cites the Revere decision as one that recognized that international law may be applicable to relationships between private parties and states, even in the absence of an express choice between the parties.

81. See *Revere Copper & Brass, Inc. v. Overseas Private Inv. Corp.*, No. 78-0296, Order at 2–3 (D.D.C. Dec. 8, 1978), aff’d, 628 F.2d 81 (D.C. Cir. 1980). The current equivalent provisions may be found in Section 5.03 of the OPIC Standard Contract, in particular, Section 5.03.3.


83. See OPIC Standard Contract, §§1.06, 1.07.

84. See *In the Matter of the Arbitration between Int’l Telephone and Telegraph Corp. Sud America (ITTSA) and Overseas Private Inv. Corp.*, 13 I.L.M. 1307 (1974).

85. See OPIC Standard Contract, §4.03(a).


87 See supra text accompanying note 38.

88. Id.

89. Id.

90. See Nicaragua Investment Agreement, supra note 38, Art. 4.
The discussion focused on five areas: “special language” and arbitral interpretations; official assistance in near-claim situations; conflict of interest for national and multilateral insurers versus behaving as an “honest broker”; the insurer requirement for notification, consultation, and consent; and the implications of Basel II.

“Special Language” and Arbitral Interpretations

Question: Underwriters are increasingly asked to provide coverage in complex and novel situations, for which they need to craft special language to avoid exposing themselves to contingencies they do not want to take responsibility. Arbitrators may subsequently take a rather different view from what the underwriters intended, looking beyond the ostensibly plain and clear policy wording in interpreting the contract. How might it be possible to guard against arbitrators looking outside of well-established bodies of interpretation when special language is used in an insurance contract?

O’Sullivan: Insurers and insureds need to pay attention to the reasonableness and prominence of new contract language, so that there is a clear record of what the parties to a contract meant when they signed the insurance contract, so that from the paper trail an arbitrator can subsequently understand that the language was negotiated and understood by both parties as critical to the interpretation of a claim.

Hansen: I agree with the recommendation to highlight special coverage details, to make it more difficult for arbitrators to ignore what
the parties intended. Problems arise because investors often want to be associated with a national or multilateral political risk insurer in a kind of partnership, so that if “things get iffy,” the insurer can “rattle its saber” alongside the protestations of the investor.

In the case of Dabhol, for instance, the language of the contract spelled out a number of events that had to occur to activate the expropriation coverage of the equity. These included termination of the power purchase agreement, arbitration of the termination, award of compensation to the investor, failure of the government to pay the arbitral award, attempts by the investor to enforce the arbitral award in courts, and confirmation of the award by the Indian courts. Essentially, the same government that expropriated the investor had to have its own courts confirm that the investor did indeed win the amount determined from arbitration. A specified time period then had to pass during which the investor was not paid. If all these events happened, the investor qualified for an expropriation payment.

Although the coverage was narrow, the investor’s goal of having a partnership with the insurer was satisfied. Despite the numerous conditions that had to be satisfied for an expropriation claim to be considered valid, when the situation became difficult, it was tempting for the investor to take advantage of this partnership and see how it might fare with an actual claim.

The arbitrators in the Dabhol case declared that the insured had experienced violations of property rights in international law at least tantamount to expropriation. They decided simply to ignore the language limiting the insured’s ability to make a claim.

Many technical lessons can be learned from the Dabhol case. It would have been more helpful if the contract had not laid out all the traditional rights and remedies and then amended them on the last page in a paragraph that undercut about 10 previous pages of text.

Nevertheless, it would be a shame to think that the lesson to be learned is that insurers should not step up and give specialized coverage, that if insurers cannot take coverage off the shelf, they should not do anything. But it is reasonable to conclude that, if the insurance is going to involve unusual coverage, the form contract should not be used. The insurer should revise the standard contract and make it very clear up front what is happening. Perhaps it should not even be called expropriation coverage; it might instead be called “special project coverage.” But it should be made very clear what is being done, because the arbitrators may bend over backward to make the insurer responsible according to their perception of the situation.
Official Assistance in Near-Claim Situations

**Question:** Sometimes investors are interested in purchasing political risk insurance from public providers in order to turn to them for assistance when problems arise. If an investor secures coverage from a national or multinational political risk insurer, what is the buyer actually getting when a near-claim situation arises?

**O’Sullivan:** Developing specialized coverage simply to have the insurer’s name on the logo can create problems for the insurer if and when an investment dispute arises. Specifically, there is a tendency to try to read out of the contract the special conditions that were written into it and act as if it were just normal coverage. Nevertheless, from the buyer’s perspective, when a national agency provides coverage, the investor obtains the involvement of the home government in a way probably not available to an uninsured investor. To be sure, some uninsured investors are able to use the political process within their countries to their advantage. But insured investors are more likely to have the home country political establishment supporting them backed by an agency with long practical experience in resolving investment disputes. So the buyer is getting some specific skills and leverage, along with the contract rights.

**MIGA representative:** Multilateral insurers increasingly see themselves as risk mitigators. They are not just providing compensation in the event of a loss but a risk mitigation service. As soon as an insured investor has a serious problem, the investor can come to MIGA for assistance, since host governments are shareholders and sit on MIGA’s board of directors. Moreover, before MIGA issues a guarantee, it asks the government to approve its issuance. If a problem arises, MIGA goes back to that government authority and requests its assistance in resolving the problem. This ensures that MIGA representations get high-level attention in the host country, allowing MIGA to resolve most disputes before they become claims.

Most investors seeking MIGA coverage expect that MIGA will help them resolve difficult problems. In recent cases in Argentina, when many insured investors requested assistance and advice, MIGA was able not only to secure an exception allowing for the automatic repatriation of scheduled loan payments but to provide investors with advice on how to respond to the new regulations.
MIGA has been so successful in acting as an honest broker that the agency, and the International Finance Corporation (IFC), are considering creating a mediation center for resolving investment disputes, even disputes over projects that MIGA has not insured.

“Honest Broker” versus Conflict of Interest for Public Insurers

Question: Can a national or multilateral agency act as an honest broker when it is also a principal with its own exposure in an investment dispute? Is there not a conflict of interest?

O’Sullivan: Despite an apparent conflict of interest, OPIC has managed to achieve a fair record of success as a mediator. When OPIC receives a prospective claim against a host government, it makes it clear that it would like to avoid making a claim payment. Then, with full disclosure all around, its tries to bring its experience to bear to resolve the investment dispute before a claim is made.

Asian Development Bank representative: In our experience, the conflict of interest exists more on paper than in reality. The only time there is a serious conflict is when the sovereign lending side of a multilateral bank, as part of its macroeconomic policy recommendation, provides advice to the host government (e.g., to cut back on government expenditures on power projects whose output is not needed) that runs counter to what has been recommended by the private project finance team, so that the project suffers.

MIGA representative: At the World Bank Group the level of coordination has steadily improved. If the World Bank intends to provide advice to a country on private investment, both IFC and MIGA participate and the advice can be more consistent. This reduces the possibility of a conflict of interest in the event that a claim arises.

Hansen: Some professionals think that the World Bank Group should be playing more of the honest broker role in mediating investment disputes.

Requirement for Insurer Notification, Consultation, and Consent

Question: An aspect of claims that is particularly troubling is the requirement for notification, consultation, and consent. On the one hand, underwriters often ask to be notified and certainly to be consulted
about some matters, so the insureds are expected to act as if they are dealing with a claim or a potential claim situation. On the other hand, underwriters often specify that insureds are required to act as if they are uninsured. Insurers do not want to commit necessarily to providing guidance when the claim has not perhaps been perfected, but at the same time insureds may be trying hard to work out a situation and seek guidance, while wanting to make sure they are not jeopardizing their policy coverage. Is it possible to have a frank discussion, to really get guidance, and to have a partnership in dealing with the situation?

O’Sullivan: OPIC’s concern arises when the insurer may be negotiating with the foreign government about uninsured investments and those negotiations may inevitably have some kind of spillover onto OPIC’s own insurance contract. In such circumstance, OPIC would want to be actively involved.

Hansen: The clause—explicit in some contracts, implicit in others—to act as if you were not insured has always made me very nervous. In the first place, it is impossible to take the meaning literally, because the insured is insured. If the insured were not insured, it might agree to take a host government offer of two cents on the dollar, because that was better than nothing. But the insured is insured and is not going to do that. Indeed, the insured’s policy would not permit it to do so.

So the insured’s behavior is obviously affected by the existence of the insurance. The question is how that behavior can be affected in an appropriate rather than an inappropriate manner. The right approach is to take those clauses out of the policy and put in what is really meant, because the meaning cannot be what the contract says.

Investment Insurance and the Implications of Basel II

Question: Financial institutions, especially banks, are subject to capital adequacy regulations. Basel II has been looking into the capital treatment of loans made by banks for projects in emerging markets. To what extent can one draw lessons from the loss experiences of investment insurers that are relevant to the capital treatment of bank loans?

An extended discussion ensued between the two speakers and several members of the audience on the implications of the Basel II agreement.

Response: A MIGA representative noted that Basel II was not designed to deal with sovereign risk. However, a footnote (#31) in the latest
version is designed to deal with a situation in which lenders have protection either under B-loan programs or guarantees provided by multilateral development banks against transfer/convertibility risk. In the event the lender has such protection and is a listed multilateral entity that meets certain conditions (including having recognized preferred creditor status), the national authorities may consider that the sovereign risk has been mitigated, thus allowing the rating of the project to float above the international rating ceiling to the domestic rating ceiling. So a project that would otherwise be rated A in a BBB country could be given an A rating, and the risk-weighting applicable to an A-rated entity would apply. Obviously, this would be available only to the banks using the internal ratings-based (IRB) approach.

A MIGA representative concluded that there is a series of tests that needs to be met for a multilateral entity to be classed as an eligible institution, one of which is that a majority of its external debt be AAA rated.
Part Two encompasses a very broad treatment of efforts to protect the international property rights of investors and a specific examination of the challenge of foreign participation in the privatization of infrastructure and the use of political risk insurance as part of project finance packages. In the first paper, “The New International Property Rights: Can the Foreign Investor Rely on Them?” Louis T. Wells, Jr., argues that political risk insurance is merely one element in an international investor’s efforts to manage political risk. Many host governments cannot make credible, long-term commitments to foreign investors. Since sovereign governments can renge on their promises (and have often done so), cautious foreign investors simply do not believe many of the commitments they receive in association with a prospective investment. This is the risk that must be managed.

Wells traces the evolution of investors’ search for ways of protecting their property rights. In the absence of a global investment agreement that would parallel the General Agreement on Tariffs and Trade (GATT) and the subsequent World Trade Organization (WTO), investors turned to piecemeal solutions to the property rights issues they faced in risky countries. The result is an unplanned, and imperfect, composite “system.”
The first and one of the oldest components was access by foreign investors to international arbitration in the event of a dispute with a host government over their rights. While there were a few investor-state arbitration cases in the first half of the twentieth century, arbitration became much more important in the 1990s. A growing number of countries allowed for international arbitration under their investment laws in the 1980s–1990s, but the growth of bilateral investment treaties and regional economic agreements is what really fueled the growing frequency of arbitration. The number of bilateral investment treaties has increased rapidly, notes Wells, and more than 2,000 exist today, nearly all of which give investors the right to go to international arbitration to settle disputes with host governments. Regional economic agreements, such as the North American Free Trade Agreement (NAFTA), also offer arbitration in one form or another to manage disputes between investors of one country operating in another member country. The development of a set of arbitral rules and forums for conducting arbitration, such as the U.N. Commission on International Trade Law and the International Centre for Settlement of International Disputes (ICSID), set some standards. The New York Convention obligated countries to enforce awards from arbitration.

The second component of the new property rights system is political risk insurance, which is offered by many national schemes, such as OPIC, and multilateral entities, such as MIGA. A third component could be considered the various types of home government support to investors, especially by the U.S. government. A fourth component could be considered the “halo effect” associated with loans from multilateral institutions and home country export credit agencies, which provides some assurance of their property rights. Wells notes that this unplanned, composite “system” is flawed in many respects and proceeds to consider the problems associated with each of the first three components.

Wells points out that arbitration provisions in many bilateral investment treaties are asymmetric: investors can take countries to arbitration, but countries do not have parallel rights to take investors to arbitration. Benefits that favor foreign investors over domestic investors are unstable; in the long run, domestic investors will either seek equal treatment for themselves or
attack the special benefits given to foreign investors. In contrast to the flexible view of contracts in industrial countries, international investment arbitration has generally not taken into account dramatic changes in circumstances. Moreover, argues Wells, decisions in international arbitrations have been somewhat erratic and on occasion unreasonably generous to the investor. One result is that some countries are hesitating to sign new bilateral investment treaties and are attempting to frustrate collection of awards from arbitrations.

With respect to political risk insurance coverage, Wells suggests that there are two types of moral hazard issues. The first relates to the insured, who obviously has less incentive to renegotiate contracts when conditions change. The greater the amount of the investment covered, the less incentive the investor has to renegotiate a deal when the time for change arises. For firms wishing to exit a project for business reasons, an investment dispute creates an opportunity to potentially collect insurance and exit the project. The second type of moral hazard lies with insurers. Since the payment of an expropriation claim allows an official insurer to turn around and seek to collect money from the host country, there may be less incentive for it to evaluate risk, monitor behavior, and deny a claim. Wells notes that there is also an element of asymmetry in political risk insurance in that official political risk insurance is available to foreign investors but not domestic firms. Wells closes by arguing that the problems associated with arbitration and official risk insurance can be solved and offers a number of suggestions.

In the second paper, “The Future of Political Risk Insurance in International Project Finance: Clarifying the Role of Expropriation Coverage,” Rick Jenney argues that recent investment disputes and arbitrations have shown that insurers and insureds have some basic misunderstandings about political risk insurance against expropriation. There has been a tendency in the past, he suggests, to regard insurance against expropriation as “big tent” coverage. But efforts to continually broaden the definition of expropriation over time have not worked.

The classic taking of assets by force or decree has become increasingly rare; expropriation claims have fallen into other categories. As a result some fundamental misunderstandings have arisen as to whether expropriation insurance covers host
government breach of contract risk, host government actions to thwart dispute resolution mechanisms (also known as “denial of justice” risk), and host government regulatory risk. These are all significant risks facing project finance investors and lenders.

Jenney examines some of the basic misunderstandings that have arisen between insurers and investors in these three areas and suggests ways of making coverages clearer and more useful to the international project finance community. He argues that if political risk insurance is to have a meaningful role in international project finance, both insurers and insureds need to better understand each other as to what existing expropriation policies cover (and do not cover) and what additional coverages can be realistically added.

With respect to host government contract risk, most insurers write expropriation policies that explicitly exclude the failure of host authorities and agencies to honor offtake contracts or purchase agreements. Typically, insurers do not intend that their expropriation coverage include contractual disputes with the host government.

Sometimes insureds argue that a blatant and deliberate breach of contract by host authorities should nonetheless be covered by expropriation insurance. But, argues Jenney, international law differentiates between a host disclaimer of any liability under a contract (abrogation or repudiation), which could be a violation, and a failure to comply with the contract. Insurers point out that the fact that a dispute involves a host government does not make it a political, as opposed to a commercial, dispute. If insureds have agreed with the host government that contractual claims should be resolved by international arbitration, the insured should be expected to use it and not expect that the presence of political risk insurance absolves them of the need to follow the dispute resolution path they have signed up for.

To avoid misunderstandings, in Jenney’s view, political risk insurance contract language should be reconstructed so that the risk of breach of contract on the part of the government—even repudiation of the contract, which would constitute a violation of international law—can be clearly and completely excluded. Some insureds would then have to turn away from expropriation coverage to address breach of contract risk, relying instead on arbitral default coverage.
Arbitral award default coverage is designed to preserve for the insured the benefits of the dispute resolution procedures, such as international arbitration. This coverage normally requires that the dispute be submitted to the arbitration mechanism spelled out in the offtake contract, that a final and binding award (not subject to appeal) be issued in favor of the insured, that the insured seek to enforce the award via the appropriate court, and that the host government fail to promptly pay the amount of the award. This dispute settlement mechanism is best able to sort out political from commercial disputes, and it can determine whether the host has a legitimate commercial reason for not making a payment. Insureds may object that international arbitration can be very time consuming, but if this is the principal concern of the insureds, they should bargain for speedier right to payment with the host authorities.

Jenney notes a number of caveats with respect to arbitral award default coverage. Insurers generally require binding international arbitration. The judgment must lead to a monetary award, not actions to compel performance or other non-monetary remedies. Finally, the arbitral award must be final, and nonmonetary remedies are not covered.

One concern that insureds have about arbitral award default coverage is the potential for the host government to attempt to thwart the international arbitration process altogether. Some of these “denial of justice” practices may be violations of international law, others may not. Denial of justice risk can lead to other misunderstandings between investors and insurers.

Like breach of contract risk, argues Jenney, denial of justice risk should be distinguished from expropriation risk. He suggests that insurers clearly and completely exclude host government denial of justice risk from their expropriation coverage. Insurers can offer denial of justice coverage alone or in conjunction with arbitral award default coverage. Many requirements and caveats should be considered by both the insurers and the insureds with respect to this coverage.

Finally, with regard to host government regulatory risk, there are many misunderstandings. Insureds have submitted claims in regulated industries alleging that changes to an offtake contract constitute an expropriatory act. Insurers generally take
the position that expropriation insurance does not cover losses due to legitimate regulatory actions taken by the host government on a nondiscriminatory basis. The key issues concern the dimensions of appropriate regulatory actions taken in the public interest when those actions impose controls over firm behavior and perhaps reduce firm profitability. Jenney argues that expropriation insurance should clearly state that the host government regulatory risk is completely excluded. If insurers intend to assume some regulatory risk, their policies can attempt to distinguish between legitimate and illegitimate regulatory acts. This will be difficult; as Jenney warns, any government can, if it chooses, frame the most egregious taking as a mere regulatory exercise (“in 1959 Fidel Castro introduced some regulatory modifications affecting the holding of private property in Cuba”).

Jenney closes by noting that the misunderstandings about expropriation coverage share a number of common elements. First, there have been many efforts by both insurers and insureds to stretch this coverage beyond its intended scope. It was never intended to address all wrongful acts of the host government or to be a form of governmental “all-risks” coverage. Second, everyone should recall the principle that political risk insurance coverage should not put the insured in a better position than it originally bargained for. Finally, the existing political risk insurance policy language needs to be improved. More direct and specific language would benefit both insurers and insureds.
The New International Property Rights: Can the Foreign Investor Rely on Them?

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This symposium carries a broad title, International Political Risk Management: Looking to the Future. Yet almost all the panels and presentations focus on political risk insurance. Insurance is only one element in a program that can enable an international investor to manage political risk. And it is only one part of what I call the new international property rights, the focus of this paper.

I will argue that a system has emerged at the international level that can help managers deal with political risk. The new system is very promising, but in its current form it is unstable and likely to be challenged. In fact, it may well collapse if the international community fails to fix its flaws.

The Basic Problem

What is the basic problem that an investor must manage? The task is implicit in the papers presented at this meeting: host countries cannot make credible commitments to foreign investors. Governments can issue promises when a firm is considering an investment. At the time, their intentions are almost certainly to keep those promises.

This paper draws on a book the author is completing. The book draws on the history of foreign investment in Indonesian infrastructure to explore how investors’ property rights have evolved.
But cautious foreign investors do not believe the commitments—and with good reason in the developing world, where sovereign governments can always renege on their promises and have often done so.

For several decades—at least from the end of World War II until the mid-1980s—many foreign investors approached this underlying problem of property rights without any international assurances. Rather, the wise and wary investor evaluated the risks for a politically sensitive project primarily by whether the investor could be reasonably sure that its continued presence would remain essential to the operation of the activity. Safest would be an activity for which the host country recognized a pressing need. Thus the investor that provided unique and necessary technology could feel safe, as could the investor that granted access to controlled foreign markets.

Safety turned on the fact that these important benefits would disappear if the host country nationalized or otherwise pressed the investor. Following this logic, IBM had its way in the developing world for years, when it maintained a clear technological lead over international competitors and domestic firms. Governments eager for the best technology had to yield to the demands of IBM for wholly owned subsidiaries, and they had to stick by their commitments. If they did not, IBM would not invest or it would leave the country, in which case the country would be a clear loser. Similarly, bauxite mines of the major aluminum companies were secure as long as the markets—alumina plants and smelting facilities—were located elsewhere and were under the control of the same small number of multinational firms that did most of the mining. Any host government that dared to nationalize a bauxite mine would find itself cut off from world markets by the major aluminum companies. Still other investors felt fairly safe, sometimes mistakenly, if their projects were small enough that they would not draw political attention.

But woe to the firm with a large or otherwise sensitive investment if the foreign owner no longer seemed essential and thus saw its bargaining power decline. When IBM’s competitors began to offer technology that was almost as good as IBM’s, the company found itself having to surrender to the wishes of host governments for joint ventures. Similarly, as the major aluminum companies lost control over international smelting capacity, they began to yield to revised deals for their bauxite mines, under the implicit threat of nationalization. In the language of the academics interested in the phenomenon, many investors eventually faced an “obsolescing bargain.”
The New System

Since the mid-1980s, a new system of protection for foreign investors has begun to offer a set of assurances based on commitments outside the host country itself. The new protections seem to provide security to firms that are not necessarily in strong bargaining positions. Although the system grew haphazardly, it reflected the strong interest on the part of multilateral financing organizations and development specialists in encouraging a broader range of FDI in developing countries than could be protected by bargaining power alone. The Washington consensus of the 1980s considered private FDI to be a useful source of capital for development, even when the investor did not bring some unique technology or access to controlled markets.

For the firm that offered little more than capital, some encouragement was needed to allay the old fears of political risk. The need to satisfy the demand for security grew as the international community became increasingly eager to encourage private foreign investors to build infrastructure—roads, power plants, water systems—in the developing world. In the case of infrastructure, foreigner investors usually brought no unique technology or access to markets. In fact, poor countries had been building infrastructure for some years without FDI, often drawing money from multilaterals in the form of loans. Without external protection, direct investors in these industries would have to be very brave, or perhaps ignorant, to enter these industries, where they would have little bargaining power once their capital was committed. If investment were to meet projected needs, some additional protection would be required.

The new system of property rights that emerged was a substitute for what many viewed as an ideal solution to the problems of foreign investment: a global investment agreement that would parallel the GATT and the WTO. These agreements set out rules for trade, but they provided few rules for investment—just enough to some national policies that had obvious impacts on trade. They did nothing to manage the political risks that could hinder foreign investment. Starting with the aborted International Trade Organization of the immediate post–World War II era, several efforts to create a similar global framework for investment came to naught. The history of failure did not encourage renewed efforts to create a comprehensive approach.

Failing a broad international framework, proponents turned to piecemeal solutions to the property rights issues of foreign investors. The resulting system, however, was not the product of any grand
design but the result of uncoordinated steps by various parties. Certainly, some of the problems of the new system derive from the lack of a single framework; even more important problems can be attributed to the lack of explicit negotiation and mutual acceptance among the affected parties.

**International Arbitration**

The first component of the new system is assured access on the part of foreign investors to international arbitration in the event of disputes with a host government over their rights. This allowed investors to escape domestic courts, which they feared would fail to protect their rights. Foreign investor-host government arbitration does not have a long and rich history. Early in the twentieth century, home countries occasionally engaged in arbitrations on behalf of their investors, but state-state arbitration differs considerably from investor-state arbitration. To be sure, there were a couple of famous cases of foreign investor-host government arbitrations in the 1930s, but until the 1960s such arbitrations remained very rare. In fact, it was not until the 1990s that arbitration grew to play a major role in protecting rights of a wide range of foreign investors.

Several steps brought the possibility of arbitration to more investors. Fairly early, contracts in mining and petroleum called for arbitration in the event of dispute. But few other agreements did so, and fewer disputes actually went to arbitration. Eventually, a few host countries included arbitration provisions in their investment laws authorizing foreign investors to go to arbitration if disputes arose. In most such cases arbitration was limited to disagreements over the application of the investment laws themselves. The real expansion of arbitration came with the growth of bilateral investment treaties. In recent years the number of bilateral investment treaties has increased, and there are now more than 2,000 in place. Although the details differ a bit from treaty to treaty, almost all give foreign investors the right to proceed to international arbitration to settle a broad range of disputes that arise with host governments.

The second vehicle for expanding the number of foreign investors eligible to turn to arbitrations has been regional economic agreements. NAFTA and many other trade agreements now include provisions that protect investors of one member country operating in another member country. Arbitration, in one form or the other, is the mechanism usually specified to manage disputes.
For arbitration to serve as a common and effective protector of the property rights of foreign investors, two steps were required beyond granting the investor access to arbitration: a set of rules to govern arbitrations and assurances that arbitral decisions would be enforceable. The World Bank-sponsored ICSID and the U.N. Commission on International Trade Law (UNCITRAL) largely established the rules. Even more important to the success of arbitration was the conclusion of the New York Convention, under which signatory countries are obligated to enforce awards from arbitration. Illustrating the impact, U.S. investors in a power plant in Indonesia are now pursuing an arbitration award against Indonesians by insisting that U.S. courts order the seizure of assets of an Indonesian state-owned enterprise located in the United States. In the absence of the New York Convention, this arbitration award would have likely proved a hollow victory for the investor, since the Indonesian courts rejected the decision.

Official Political Risk Insurance

The second component of the new property rights system is official political risk insurance—insurance offered by the World Bank Group, through MIGA, and insurance marketed by investors’ home governments, such as that provided by the U.S.-based OPIC. Although the U.S. government has offered insurance coverage for foreign investment since the days of the Marshall Plan, coverage was originally sought by firms largely to cover the risk that dividends could not be converted into dollars.

Over the intervening years, OPIC has expanded its political risk coverage, moving from covering primarily outright expropriation to adding coverage of other acts by governments that might diminish the returns from a project. So-called political risk coverage now makes up the bulk of the business of OPIC and other official insurers. Breach of contract seems to have become the most common claim by insured investors as coverage expanded to deal with “creeping expropriation.” Of course, official insurance can be priced low, since the threat of sanctions by the organizations backing the insurance sharply reduce the chances of the events being insured against occurring. Moreover, if the feared events do occur, official insurers usually have the power to force host countries to reimburse them for claims they pay, which is likely to reduce the likelihood of the events occurring. The official agencies act as much as guarantors as insurers for investors.


Home Government Support

The third component of the new international system of property rights is home government support of foreign investors, particularly U.S. government intervention. Official U.S. support of its investors abroad expanded dramatically in the 1990s. The United States always made noises when an American investor was threatened abroad, but between World War II and the 1990s, real action by the government was quite rare. The government held the tools to protect investors, if it chose to use them. For example, it could draw on the Hickenlooper Amendment to cut off aid to an offending government, it could turn to the Gonzalez Amendment to have its directors in multilateral financial organizations vote against loans to naughty host countries, and it could withdraw privileges under the Generalized System of Preferences from countries that took U.S. property. But these powerful tools were very rarely used. The Hickenlooper Amendment, for example, was used only twice before 1990. In practice, when a dispute arose between a U.S. investor and a developing host country, officials in the local U.S. Embassy and the State Department usually argued that if the U.S. government were to take strong actions against the host country, it would annoy that government, in the extreme case, pushing the host country toward the communist camp. The U.S. Treasury or the Commerce Department often argued the other side, contending that the U.S. government must protect U.S. investors abroad. In the heat of the Cold War, State’s was usually the winning argument over proponents of intervention.

To be sure, the U.S. government did occasionally intervene, but it did so largely when there was an alignment of interest between foreign policy and the investor or when barriers prevented access to a market by U.S. firms in the first place. (Petroleum provided most examples of the first type.) But otherwise, strong actions to support investors were the exception.

By the early 1990s the fear of communism had waned to the point that it no longer provided a convincing reason to hold back support for investors. At the same time, the U.S. Senate Foreign Relations Committee (especially under Sen. Jesse Helms) was challenging the budget for overseas representation. Having lost its trump card of the communist threat and needing a way to convince Congress to maintain the Department’s appropriations, State Department officials turned to supporting U.S. businesses abroad. In fact, in interviews, embassy officials told me that in the 1990s young Foreign Service officers were taught in their department training that service to business
was the way to increase their budget. The result was a wave of help to U.S. investors abroad that played a role in assuring their property rights.

Official Credit

A fourth component can also be considered part of the new system of property rights protection. Investors often view loans from multilateral institutions and home-government export credit organizations as providing some assurance of their property rights abroad. The argument is similar to that for official insurance: host countries will not mistreat investors that have such loans, because the countries would risk the wrath of the multilaterals or home governments. Of course, the assurances are most credible when the lenders have a record of intervention.

Weaknesses in the System

This unplanned system is fragile. Its weaknesses are already leading to challenges, evident in the hesitancy of some countries to sign bilateral investment treaties and in attempts to frustrate arbitrations. Those interested in maintaining some assurances that encourage foreign investment need to address some of the flaws if the system is to survive. Three important components of the system—arbitration, official insurance, and U.S. government intervention—need addressing.

Arbitration

In recent disputes, arbitrators have taken an extremely rigid view of contracts, easily ruling that contracts have been breached. In doing so, they have rarely taken into account significant changes in economic conditions that might have made adherence to contracts uneconomic or, in some cases, extremely burdensome for the host government.

In contrast to the approach of international arbitrators, courts in industrial countries often do not insist on rigid adherence to the terms of a contract in the face of sharply changed and unforeseen conditions. Courts often reject requests for large awards when strong economic reasons justify one party’s actions. To be sure, in industrial countries some award will be made to the harmed party if a contract has to be broken for economic reasons, but the award is
likely to be less than the full value of the contract. Say, for example, a homeowner contracts with a painter to paint his house. If the house burns down before the painter gets around to doing the work, he surely will not be required to paint the ashes, and the owner will likely not be obligated to pay the full amount of the contract. If the parties to the contract were foolish enough to go to court, a judge might decide that the owner has to pay for the paint the painter had bought and perhaps some fraction of the cost of labor, so that the painter has time to put the laborers to work at another task.

The discharge of debts by bankruptcy court is another illustration of the flexibility of property rights in industrial countries. Much of the argument for discharge in the United States was originally based on some version of the economic argument that preserving entrepreneurs was more important for development than protecting creditors. To accomplish this, debt instruments could be overruled.

In contrast to practice in industrial countries, arbitrators have, on a number of occasions, awarded investors the full amount the investor had put up so far plus some large fraction of the net present value of future earnings (at least 30 years’ worth, in some cases), even when contracts had been broken for economic reasons. And this for projects that had not even been completed. If such outcomes become expected, investors will discover an incentive to look for the riskiest projects and, when a breach of contract occurs, claim the return of the sum they invested as well as future profits. They will then be able to invest the proceeds somewhere else, where they might again hope that the government breaches the contract. In fact, they may even take steps to encourage breach.

To illustrate the incentive, I ask students what would happen if following the failure of a bank, the Federal Deposit Insurance Corporation would pay depositors the amount of the principal plus 30 years of interest. When faced with this possibility, students who had not been very interested in evaluating the financial strengths of their banks suddenly became eager to find the riskiest institution for their deposits, in the hope that the bank would fail and they could collect the principal and interest.

Similarly, arbitrators have rigidly upheld contracts even when their terms suggested that they might have been negotiated corruptly or under pressure from investors’ home country governments or where governments might have cancelled them under pressure from the IMF or World Bank.

Arbitrators have rarely responded to reasonable claims that contracts were the unreasonable result of corruption or compulsion.
They have insisted on the standards of proof of corruption or compulsion, which can almost never be met. In contrast, in industrial countries, courts may override contracts even if there is only a whiff of corruption or compulsion. To cite only one example, courts in the United States often refuse to enforce unusual terms in premarital agreements that were signed at the last minute before the wedding and without independent counsel for one party. Without other evidence, they assume some degree of compulsion.107

Perhaps equally disturbing, decisions in international arbitrations have been erratic. The most striking evidence of inconsistency has been provided by the various rulings with respect to the CME-Czech Republic arbitrations.108 In separate arbitrations of essentially the same issue, awards differed greatly. There is no general consensus on principles, especially in calculating awards.

Moreover, and of politically great significance, the provisions that call for arbitration in bilateral investment treaties and in regional economic agreements are asymmetric. To start, investors can take governments to arbitration, but under many arrangements governments do not have parallel rights to take investors to arbitration. One might argue that this is a moot point. It is, however, potentially very important politically and is likely to become increasingly sensitive. Indeed, the asymmetry may even be important in practice. A recent study suggests that more than half of contract changes in infrastructure investments in Latin American were initiated not by the government but by the company.109 The study suggests that companies underbid to obtain contracts and then, rather than honor their commitments, reopen negotiations in order to increase their returns. Governments that face demands from companies for renegotiation of agreements have little recourse. They could turn to domestic courts, but their decisions are not likely to be honored abroad, where the investor has assets that might be seized in compensation for failure by the company to fulfill its commitments. If a company can take a host government to arbitration for failure to honor a contract, why, one might reasonably ask, should a host government not have a similar right when a company fails to live up to its contractual commitments?

In an additional kind of asymmetry, bilateral investment treaties and regional economic agreements offer protection to foreign investors without providing similar rights to domestic investors. The history of incentives that favor foreign investors over domestic firms suggests that favoritism will not last. Eventually, domestic firms exert pressure for equal treatment, by seeking the same benefits for themselves or by attacking the special benefits available to foreign investors.
The expansion of official political risk insurance has also generated problems. Official coverage tends to view any breach of contract by government as an act that will trigger a legitimate claim. The expectation that contract terms can be frozen for, say, 30 years is simply not realistic. Further, official insurers have paid little attention to strong hints of corruption underlying the terms of the original contract.\textsuperscript{110} Eagerness for business and, perhaps, political pressures have led agencies to insure very questionable projects, and they have been hesitant to deny claims once they are filed for these projects. Thus official political risk insurance parallels international arbitration in its rigid interpretation of contract and, at least on some occasions, its reluctance to challenge questionable deals.

Like most other insurance, political risk coverage potentially poses two kinds of moral hazard. The first is typical of many kinds of insurance. The insured has less incentive to renegotiate contracts when conditions change than if it were without insurance and had to face the full consequences of refusal. At a minimum, the insurance puts a floor on the investor’s best alternative to a negotiated agreement (BATNA). The greater the percentage of the investment covered, of course, the less incentive the investor has to renegotiate a deal when the time for change arrives.

It is difficult to determine how much this kind of moral hazard influences actual decisions by insured companies. Some evidence with respect to disputes over power projects in Indonesia in the 1990s is suggestive, however. In a few cases it appears that collecting insurance rather than renegotiating new terms proved especially tempting for companies that were taking steps to exit projects in developing countries anyway.\textsuperscript{111}

In private markets with similar moral hazards, insurers screen their clients carefully and monitor behavior to reduce the risk of moral hazard. It is not clear that official insurers behave the same way. In some cases, the desire for more business seems to lead to bad decisions about offering insurance.

A second kind of moral hazard may help explain the behavior of official agencies. More important, it explains some of the doubts about them in the developing world. This particular kind of moral hazard lies with the incentives for the insurer’s behaviors. Since “treaties” authorize an official insurer (say, OPIC or MIGA) to turn around and collect its money from the host country if it pays a claim, there is less than the usual incentive for the insurer to evaluate risk...
and monitor behavior and little incentive to deny claims. It may be easier to succumb to political pressure at home mounted by investors than to question whether a payment ought to be made. Whatever the actual behavior of insurers, which is difficult to document, host countries harbor fears that insurers do not question claims carefully. Perceptions may be as important as fact. But the infrequency with which claims seem to have been challenged suggests that the matter may involve more than perception.

The fears of host countries are reinforced by the fact that the host country is likely to see little right of challenge to the payment of insurance by an official agency. So far OPIC refuses to provide copies of insurance contracts to host countries when the agency comes around to collect on a claim it has paid. Thus the host country has no means of judging the legitimacy of the claim. It is difficult to support the lack of transparency from a government that encourages transparency abroad. The justification offered is that the insurance document contains business secrets and thus has to be kept confidential. This is not very credible when the covered project is already dead. This lack of transparency is likely at some time to become a politically contentious issue.

Similar to the rights to arbitration, political risk insurance has an element of asymmetry. Official insurance is available to foreign but not domestic firms. Although probably not as sensitive as rights to arbitration, this asymmetry may eventually pose some challenge to MIGA, OPIC, and other national agencies.

Official political risk insurance is likely to become contentious for still another reason. In recent years, official insurers have entered collection compacts with private insurers. Under these compacts the official insurance organizations agree to collect from offending host governments on behalf of private insurers in the event of a claim. In such compacts, private insurers gain the power of, say, the World Bank or the U.S. government in recouping any claims they pay out. It is doubtful that developing countries envisioned this sort of extension of insurers’ power when they entered the authorizing treaties for MIGA or OPIC coverage.

**Home Government Support**

The difficulties that threaten home government support for investors are of a very different kind. In foreign relations, countries can use their “chips” on only a limited number of issues. The United States
recognized the primacy of the Cold War in its foreign policy until about 1990. Only after that did protection of private investors move up to a high priority. With the war on terrorism, the U.S. government may find a new issue dominating its foreign policy agenda. If it does, it is likely to back off from its strident defense of its investors abroad.

Solving the Problems

The problems with arbitration and official political risk insurance can be solved. While I cannot lay out a program for correcting the system’s faults, I can give some sense of direction.

There are alternative models of arbitration (such as amiable composition) on which new approaches could draw. Proposals are multiplying for the creation of standing review panels that would bring more consistency and legitimacy to awards. Moral hazards connected with insurance can be overcome if investors and official agencies are forced to carry more of the risk themselves. Coverage of risk could be for a smaller portion of investment, and reimbursement by host governments could be only partial, for example. Efforts to mediate disputes, rather than require arbitration before the insurer becomes involved, may reduce (or at least identify) the first kind of moral hazard. Distancing official insurance agencies from political interference and pressures to expand their business could enable them to evaluate potential corruption more thoroughly before they issue insurance. Denying insurance would be better than having to challenge claims later, when the standard of proof is likely to be high.

Increased transparency could alleviate some of the suspicions harbored by host governments. Some progress could be made if official insurers would adhere to the kinds of transparency they advocate for developing countries.

Easier ways for host governments to challenge insurance awards (including more transparency) would serve as a more effective brake on the second kind of moral hazard (not disputing claims since the host country will reimburse the insurer). Although some official insurance agencies claim that they are already disciplined by the threat of host government challenge, the host governments I have worked with believe that they have no real rights, given the threats posed particularly by investors’ home countries. There are already proposals that MIGA cover domestic firms for political risk, although strong doubts remain as to the proposal’s feasibility and acceptability. Official insurers could follow their own advice with respect to
privatization by not using the power of the state to collect on behalf of private insurers. Left to their own devices, the private sector will assess risks, determine rates that reflect those risks, and provide an insurance market. Official entities can fill gaps that demand intervention for social reasons. Their activities should not be confused with those of the private sector, however, as they increasingly are.

Notes

91. An exception existed for the calcine bauxite mines, since their ores bypassed the smelters controlled by the vertically integrated aluminum companies.


95. Often cited are the Lena Goldfields arbitration of 1925, between a British company and the Soviet Union, and the 1935 case of Radio Corporation of America v. China, brought under the Permanent Court of Arbitration in the Hague, which agreed in the 1930s to consider cases brought by private parties against states.


98. Technically, claims may be awarded on the basis of “denial of justice.”


100. For documentation of these positions, see Wells, Louis T. Forthcoming, “Protecting Foreign Investors in the Developing World: A Shift in U.S. Policy in the 1990s?” In International Business-Government
100 Louis T. Wells, Jr.

Part Two


101. At the time of writing, Pakistani officials were having second thoughts about expanding their network of bilateral investment treaties. For allegations that Indonesians kidnapped an arbitrator to frustrate an arbitration, see Martin, Julie A. 2001. “OPIC Modified Expropriation Coverage Case Study: MidAmerican’s Projects in Indonesia-Dieng and Patuha.” In International Risk Management: Exploring New Frontiers, ed. Theodore H. Moran pp. 58–68. Washington, DC: World Bank. Others challenge the story in this case. Whatever the truth, there is agreement that an Indonesian court intervened to challenge the arbitration. Lawyers for Pertamina, the Indonesian state-owned petroleum company, challenged in five countries the collection efforts by the owners of Karaha Bodas Company to collect an arbitration award. For parts of the story, see Hull, C. Bryson. “U.S. Court Says Pertamina Can Fight $261 mln Award,” Dow Jones Business News, June 20, 2003. See also Anderson, Mark H. “U.S. Top Court Won’t Intervene in Pertamina/Karaha Dispute,” Dow Jones Business News.


104. The awards against Indonesia in MidAmerican’s Dieng and Patuha projects and the Karaha Bodas case, all geothermal power plants in Indonesia, illustrate the point.

105. Most of the Indonesian power projects of the 1990s involved local powerful shareholders who did not put up money or physical assets for their shares, which they obtained either at no cost or through loans extended by foreign equity holders that were to be repaid out of withholdings from future dividends. None of the three arbitrations involving these projects seriously investigated the arrangements. To be fair, however, Indonesians did not provide evidence of corruption in the hearings; it seemed that too many of the parties involved were still powerful.
106. Representatives of the IMF refused to confirm or deny allegations by Indonesia that the Karaha Bodas geothermal project had been cancelled under pressure from the IMF.

107. I am aware of no cases of investment arbitration that parallel the U.S. courts’ approach to premarital agreements. There seems to be no presumption that lopsided contract terms might reflect corruption, compulsion, or incompetence by the losing party, although some have argued in favor of this view.


110. OPIC contracts contain clauses that invalidate insurance coverage if the investor violates the U.S. Foreign Corrupt Practices Act; MIGA contracts refer to violations of local law. U.S. investors in Indonesian power projects in the 1990s exploited a loophole in the Act. Shares went to local powerful partners who were not technically government officials, including children of the Indonesian president. The U.S. Justice Department responded to an inquiry I submitted by saying that gifts to family members of officials were not violations of the Foreign Corrupt Practices Act unless the gifts were an explicit condition of obtaining the business; in most Asian cultures such an “explicit condition” would be impossible to prove. MIGA insured an Enron project, even though its partner was a son of the president. MIGA did not deny the eventual claim on the project; at that point the standard for proof of corruption was probably higher than could be reasonably satisfied. OPIC insured CalEnergy/MidAmerican’s geothermal project in Indonesia, which was also negotiated under suspicious circumstances. The eventual claim was paid with little serious investigation of the arrangements with its politically influential partners. Presumably both decisions with respect to the awards were technically correct. Whether the projects should have been insured in the first place, given what was known, and whether the claims awards were “right,” in a nonlegal sense, are another matter.

111. MIGA has paid a political risk insurance claim to Enron for a power project in Indonesia. At the time, Enron was divided internally over whether hard assets, such as power plants, should be part of its future. It is difficult for an outsider to tell whether Enron’s decision not to renegotiate but to instead collect its insurance was driven by those who wanted out of such investments. The commitment and the insurance claim were, in any event, relatively small by the time the contract was terminated. In the case of CalEnergy/MidAmerican in Indonesia,
insured by OPIC, the circumstantial evidence for moral hazard is
greater and the sums of money involved much larger.

112. More technically, the insurance agency takes over the investor’s
claims.

113. For example, in MidAmerican’s geothermal power case,
Indonesians requested a copy of the insurance contract when OPIC
came around to collect what it had paid to MidAmerican. OPIC refused
to provide it.

114. I am grateful to Jeff Meller for bringing this alternative
approach to arbitration to my attention.

115. MIGA appears to have made an almost heroic effort to medi-
ate the Enron power dispute in Indonesia. Whether these efforts ever
had a chance is unclear; the Indonesians were not well organized, and
Enron was going through an internal struggle that was to lead the
company to withdraw from hard assets, such as power plants. It seems
that MIGA made similar efforts in other disputes, with more success.
In contrast, in a similar dispute in Indonesia, MidAmerican quickly
went to arbitration; there is no evidence that OPIC was involved in
trying to mediate a settlement. Whether OPIC managers did not see
their charge as including early intervention before arbitration, or
whether the company was not interested for moral hazard reasons is
difficult to ascertain. In any event, the arbitration so spoiled relations
that later mediation would have served no purpose.

116. MIGA and OPIC insured Indonesian power projects knowing
who the local partners were. Both would have been better off if they
had refused to insure projects about which there were suspicions of
corruption.

117. In the case of the Indonesian power contracts, U.S. threats
emerged quickly. Given the tools at the disposal of the U.S. govern-
ment, the threats would make any host country hesitant to mount a
serious challenge, especially a country in the midst of a major eco-
nomic crisis for which foreign help was being sought. The World Bank,
in contrast, did not issue threats against Indonesia when MIGA sought
reimbursement for its Enron claim. MIGA did have a somewhat easier
job, since the amount of money at stake was much smaller than that
involved in the OPIC claim. The difference, however, is not sufficient
to explain the sharply different behavior of the two agencies.
Recent disputed claims and arbitrations with respect to projects in Argentina, Asia, and elsewhere have revealed what many observers have long suspected: insurers and insureds have some basic misunderstandings about political risk insurance coverage for expropriation.

A classic taking of an investor’s assets (typically by means of tanks and soldiers) is clearly covered, and an outright appropriation of an investor’s rights (typically by publication of a decree) is plainly a taking. But recent claims have not fallen into these neat categories. Instead, recent claims have revealed fundamental misunderstandings as to whether expropriation insurance covers host government breach of contract risk, host government actions to thwart dispute resolution mechanisms (known as “denial of justice” risk), and host government regulatory risk. These are not small risks for international project finance investors and lenders. Recent experience has shown that whether or not they are covered, these three risks may now be greater than the risks of classic expropriation.

If political risk insurance is to play a meaningful role in the future of international project finance, insurers and insureds need to better understand each other as to what existing expropriation policies cover (and do not cover) and what additional coverages can realistically be added (and at what price). This paper examines the basic misunderstandings concerning these three risks and suggests a few approaches for making coverages clearer and more useful to the international project finance community.
Misconceptions about Host Government Contracting Risk

Breach of Contract Risk Typically Excluded

Insureds often mistakenly assume that a significant breach by a host government party of its payment obligations (under an offtake contract, such as a power purchase agreement, for example) is—or at least should be—a covered expropriation under a political risk insurance policy. However, insurers intend that expropriation coverage not include contractual disputes with the host government. Therefore, most expropriation policies expressly exclude from the scope of coverage any failure of the host government (or its relevant agency) to honor its obligations under any purchase agreement or support document in favor of the project company. Typical exclusion language might be as follows: “This policy does not cover losses arising from any action taken by the Host government (or any entity controlled by the Host government) in its capacity or through its powers as a supplier, creditor, shareholder, director or manager of, or purchaser from, the Project Company.”

Breach of Contract Not Covered Even If Not Expressly Excluded

Despite exclusions, insureds often argue that if a breach of contract by a host government is blatant and deliberate, it should be covered by the general concept of “expropriation.” However, most political risk insurance policies require that an action be a violation of international law to be expropriatory. However, a host government’s breach of contract with a foreign insured is generally not a violation of international law. The prevailing international law standard makes a clear distinction between abrogation or repudiation of a contract—in essence the host government tearing up the contract—which could constitute an expropriation and lesser nonperformance that is a mere breach of a contract, which is not an expropriation.

Repudiation has been interpreted narrowly as meaning an outright disclaimer by the state of any liability under the contract. In contrast, breach of contract does not constitute expropriation unless it makes impossible the continued operation of the project that is the subject of the contract—that is, the functional equivalent of repudiation of the contract.

Recent international law cases confirm this distinction. An ICSID tribunal convened under a North American Free Trade Agreement (NAFTA) proceeding issued a unanimous award holding that a
significant breach of an investment agreement was not “tantamount to expropriation” for purposes of NAFTA, Article 1110. The tribunal noted:

The mere nonperformance of a contractual obligation is not to be equated with a taking of property, nor (unless it is accompanied by other elements) is it tantamount to expropriation. . . . [I]t is one thing to expropriate a right under a contract and another to fail to comply with the contract. Noncompliance by a government with contractual obligations is not the same thing as, or equivalent or tantamount to, an expropriation.\textsuperscript{118}

\textit{Insurers’ Rationale}

Exclusion of contract risk from expropriation coverage is based both on the underlying theory and the practical economics of the political risk insurance business. The theory has two components. First, just because a dispute involves the host government does not make it a political dispute. A dispute with a government may be commercial, political, or (more often) a mix of both.

Second, political risk insurance should give the insured no more than what it bargained for. If the insured agreed with the host government that all contractual claims are to be resolved by international arbitration, then, having bargained for a particular dispute resolution mechanism, the insured is expected to use it.

The reality is much starker: host government contract breaches far outnumber true expropriations, both in number and in dollar amount (especially considering lump-sum termination payments, which are typical). Payment of breach of contract claims is not contemplated in expropriation coverage underwriting and would bankrupt many political risk insurers.

\textit{Some Suggestions on Breach of Contract Risk and Expropriation}

Whatever their understanding is when they purchase expropriation coverage, insureds can be sorely tempted to make an expropriation claim when a significant breach of contract occurs, especially if it relates to nonpayment for which there is no legitimate commercial justification. Therefore, policy language needs to be clearer that host government breach of contract risk is not merely insufficient by itself to constitute expropriation but is completely excluded from expropriation coverage. In other words, even a breach of contract that
constitutes a repudiation (and therefore might rise to the level of an expropriation) should be carved out of the definition of expropriation and not be covered.

An exclusion that is more direct than the “action taken by the host government in its capacity as a purchaser from the Project Company” language could be useful. Some insurers have started to include language such as this:

This policy does not cover losses arising from any contractual claim (including without limitation with respect to termination) made under any of the Transaction Documents or any other agreement with the host government, including all existing claims or potential claims that are within the scope of issues eligible for resolution by means of the dispute resolution mechanisms in such agreements.

Of course, simply excluding the risk does not solve the problem for investors. Because insureds recognize breach of contract risk as a risk they cannot adequately manage or mitigate, there is a healthy demand for a political risk insurance product that addresses it.

**Misconceptions about Arbitral Award Default Coverage**

Instead of relying on expropriation coverage for breach of contract risk, insureds should turn to (and be forced by clearer expropriation exclusions to turn to) the coverage that is designed for breach of contract risk, namely, arbitral award default coverage. Arbitral award default coverage is nothing new: it has been available for years in various forms from most public and private insurers. It is separate from expropriation coverage and is designed to preserve for the insured the benefits of a dispute resolution procedure such as international arbitration.

The normal requirements for arbitral award default coverage are as follows:

1. A dispute between the insured (or the project company) and the host government is submitted to the international arbitration procedure contained in the offtake contract.
2. The arbitral procedure yields a final and binding award, not subject to appeal, in favor of the insured (or the project company).
3. The insured (or the project company) seeks to enforce the arbitral award in a court of competent jurisdiction.
4. The host government fails to pay the insured (or the project company) the amount of the arbitral award within a short waiting period (60–90 days) of the date of such attempted enforcement. Under arbitral award default coverage, commercial disputes between the parties must first go through arbitration. The dispute resolution mechanism, not a political risk insurer, is best able to distinguish between a commercial dispute, in which the host government has a legitimate reason for not making a payment, and a political action by the host government, in which the host government is just making excuses.

*Is Arbitral Award Default Coverage Good Enough?*

Many insureds are dissatisfied with coverage that requires completion of an international arbitration, which can often take years. But insurers note that arbitral award default coverage puts an insured in exactly the position it bargained for with respect to commercial disputes with the host government: the dispute should be resolved through arbitration, and if the host government is the losing party, it should pay.

Insurers point out that a political risk insurance policy that pays sooner than could be reasonably expected under the contract (e.g., when the dispute arises) would improve rather than maintain the insured’s bargained-for position. Political risk insurance policies are not letters of credit.

If insureds want a clearer and faster right to payment without resort to arbitration, they should bargain for it with the host government. Indeed, this is exactly the principle behind OPIC’s recent introduction of nonhonoring of government guaranty coverage. If a host government is willing to issue a standard unconditional financial guaranty, in which payment is not subject to any realistic possibility of defenses or commercial disputes, OPIC is willing to insure payments on that host government guaranty without resort to a dispute resolution mechanism.

*Caveats about Arbitral Award Default Coverage*

Not every host government is willing to issue an unconditional financial guaranty, so most insureds must instead use arbitral award default coverage. Insureds should consider a few caveats with respect to this coverage.
First, insurers generally require that the dispute resolution mechanism provide for international arbitration. An international arbitral award is recognized under enforcement treaties and conventions as a binding obligation in other countries party to the same convention.

Second, mediation and conciliation procedures and other less formal dispute resolution mechanisms, such as resort to a special master or other expert, have a lesser degree of enforceability. This generally means that anything other than binding arbitration is not insurable.

Third, only contractual dispute resolution mechanisms are insurable. International arbitration under bilateral investment treaties or the GATT, for example, would not be covered.

Fourth, insurers normally prefer to cover only disputes that would result in a monetary award to the investor. This means that actions to compel performance and other nonmonetary remedies are not covered.

Fifth, the arbitral award must be final and nonappealable under the rules of the dispute resolution procedure. Most dispute resolution procedures provide for only limited rights of appeal. Normally, an arbitral award can be treated as being final and nonappealable notwithstanding the fact that it is subject to challenge or contest by the host government in the courts of the host country or otherwise outside the dispute resolution procedure.

Sixth, the arbitral award must meet the customary standard for enforceability of legal obligations, namely, that it be valid, binding, and legally enforceable against the host government. This does not require that the award be “practically enforceable,” in the sense that there is a likelihood of being able to successfully enforce it and get paid, but only that the award is in proper legal form for enforcement.

Despite these caveats, arbitral award default coverage in most cases preserves the benefit of the insured’s bargain. Especially when coupled with denial of justice protection (discussed below), arbitral award default coverage offers strong protection for investors and lenders.

**Misconceptions about Denial of Justice Risk**

**Concerns about Denial of Justice**

One concern that insureds have about arbitral award default coverage is the potential for the host government to thwart the international arbitration process altogether. Arbitral award default coverage
requires that there be a final and binding arbitral award against the host government. Despite its much-touted advantages over litigation, international arbitration in most instances remains a long process. Insureds are concerned that deliberate foot-dragging by the host government might bring an already slow arbitration process to a complete halt, thereby preventing an arbitral award from being issued.

Host government actions of concern may include refusal to participate in agreed upon arbitration procedures, frustration of arbitration procedures, and actions rendering arbitration impossible or impracticable. In recent cases host governments have obtained injunctions in local courts against arbitration proceedings, had fines levied against parties involved in arbitrations, and even detained arbitrators in an effort to thwart the arbitration process.

In more extreme circumstances these actions may amount to what is called “denial of justice” and constitute a violation of international law. Although the instances just mentioned are clear-cut cases, in general denial of justice concepts are murky and can lead to confusion about coverage.

Insureds contend that because denial of justice is a violation of international law, it should be covered if a policy’s expropriation provisions require that host government actions be violations of international law. Insurers contend that denial of justice may constitute a separate basis for host government responsibility under international law but that not every denial of justice circumstance constitutes an expropriation under international law.

The recent international arbitration between OPIC and two of the sponsors of the Dabhol project in India did not provide additional clarity. The sponsors were unable to pursue the arbitration to obtain an arbitral award that was required under the OPIC policy, but they were nevertheless found to be entitled to payment under that policy on a denial of justice theory.

Some Suggestions about Denial of Justice Risk and Expropriation

What can be done to address denial of justice risk? The first step is to distinguish it from expropriation risk. Therefore, as with breach of contract risk, policy language needs to be clearer that host government denial of justice risk is completely excluded from expropriation coverage.
Following the Dabhol case, some insurers have expressly carved out denial of justice events from expropriation coverage, with provisions such as this:

For the avoidance of doubt, none of the following shall constitute an Expropriatory Act: (a) any failure or refusal by the Host government to submit to or participate in any adjudication, arbitration or related dispute resolution mechanism, (b) any frustration by the Host government of any adjudication, arbitration or related dispute resolution mechanism, (c) any action by the Host government rendering adjudication, arbitration or related dispute resolution mechanism impossible or impracticable, or (d) any failure or refusal of host country courts to permit access to foreign arbitration or related dispute resolution mechanisms or other contractual remedies.

Instead of relying on expropriation coverage for denial of justice risk, insureds should be forced by clearer exclusions to turn to express denial of justice coverage.

**Overview of Denial of Justice**

Insurers offer denial of justice coverage on a stand-alone basis or in conjunction with arbitral award default coverage, but it is available only in a specific set of circumstances. The typical requirements for coverage are as follows:

1. The insured must have submitted the dispute to arbitration or another approved dispute resolution procedure. Note that “submitting the dispute” is broader than “initiating the dispute resolution procedure.” Host government attempts to block the arbitration that results in the arbitral panel not being named can be said to have prevented the initiation of the arbitration.
2. The initiation of the dispute resolution mechanism must be timely. Some insurers may prefer to add a stated time period (e.g., “no later than 180 days after the disputed payment was originally due”) to avoid stale claims.
3. The insured must diligently pursue the specified dispute resolution procedure. This may be subject to varying standards (e.g., “use its best efforts” or “use all reasonable efforts”).
4. There must be wrongful failure or refusal by the host government to submit to or participate in the dispute resolution procedure. Note that this is described as action or inaction by the host government.

5. Arbitration must be rendered impossible. Wrongful failure or refusal by the host government must principally and directly cause the invocation, operation, or formal conclusion of the dispute resolution procedure to be rendered impossible or prevented from proceeding as provided by the rules of the dispute resolution procedure and the terms of the covered agreement.

6. Generally, the failure or refusal by the host government must last for a continuous period, typically 365 consecutive days. This period of time is required to elapse before an additional short waiting period (e.g., 30–60 days) that allows the insurer to attempt to resolve the dispute.

Caveats about Denial of Justice Coverage

Insureds must consider a few caveats with respect to denial of justice coverage. First, as with arbitral award default coverage, frustration of international arbitration under bilateral investment treaties or the GATT is not covered.

Second, denial of justice is usually limited to actions of the host government itself, although some insurers may be willing to include action (or even inaction) by any agency, authority, ministry, company, or other entity controlled by the host government.

Third, the host government action must be wrongful, in the sense that it is not a legitimate legal defense or procedural requirement under applicable law.

Fourth, the dispute resolution procedure must be completely halted, not merely interfered with.

Some insurers have experimented with lower standards with respect to the required consequences to the arbitration process of the wrongful host government action. For example, some insurers offer coverage in the following circumstances:

- The process has been rendered futile. This is a lower standard than impossibility. In this case, the dispute resolution procedure may not have been completely halted, but going forward has become pointless. (Exactly when a process becomes pointless is admittedly a bit vague.)
The process has been obstructed, frustrated, or thwarted. This is a significantly lower standard than impossibility. The dispute resolution procedure must be interfered with, but it need not be completely halted.

The process has been rendered impracticable or ineffective. This is a low standard, and so is rarely used. The dispute resolution procedure must only be rendered less practical or effective than some unspecified standard.

Finally, denial of justice coverage does not typically address inability to arbitrate due to deterioration in conditions in the host country (e.g., due to political violence or other unspecified problems not directly caused by the host government). However, some insurers offer denial of justice coverage if the arbitration process has been rendered exceptionally hazardous to the physical safety of representatives of any required party. This is special coverage to address threats to the insureds’ representatives. In some cases this concept can be broadened to include “witnesses on behalf of any required party,” although this broadens the coverage substantially, since one credible threat to one witness would allow a claim.

**Misconceptions about Host Government Regulatory Risk**

*Regulatory Risk Typically Excluded*

A final area of misunderstanding about expropriation concerns host government regulatory risk. Insureds have recently submitted claims for projects in regulated industries (such as power and water) alleging that changes to an offtake contract, or to the regulation of the industry itself, constitute expropriatory acts. Insurers intend that expropriation insurance not cover losses due to nondiscriminatory measures by the host government in the exercise of its legitimate regulatory authority. However, it is not difficult for a host government to frame an expropriatory action as a regulatory measure, and exactly what action is “legitimate” is a complex question.

Many policies contain an exclusion such as the following:

This policy does not cover any loss or damage resulting from nondiscriminatory measures of general application of a kind that governments normally take in the public
interest for the purposes of ensuring public safety, raising revenues, protecting the environment, or regulating economic activities.

This traditional language is helpful, but it does not answer the hard questions: What is the meaning of “normally”? What is the definition of “the public interest”? How broadly should arbitrators construe a phrase such as “regulating economic activities”?

Lack of Guidance from International Law

International law does not draw a clear line on this issue. Regulatory actions taken by a government may be tantamount to expropriation under international law when those regulatory actions impose severe restrictions on the use or enjoyment of the investor’s property. By one common (albeit not universally accepted) standard, a wrongful taking may occur if a state subjects investors’ property to “taxation, regulation, or other action that is confiscatory, or that prevents, unreasonably interferes with, or unduly delays, effective enjoyment of an alien’s property or its removal from the state’s territory.”119

However, a state is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind commonly accepted as being within the police power of a state if it is not discriminatory and not designed to cause the investor to abandon the property to the state. Such measures will not be deemed expropriatory merely because they may conflict with investment and diminish profitability.

On top of this framework, a number of recent arbitration decisions have analyzed what constitutes a regulatory “taking” under customary international law. Whether a regulatory act is tantamount to an expropriation may rest on factors such as the degree of interference with the investor’s property interest, the degree to which the regulation deprives the investor of effective control over the enterprise, and whether the regulation makes it impossible for the firm to operate at a profit.

But is “tantamount to expropriation” the same thing as “expropriation” for purposes of a political risk insurance policy? Many NAFTA cases expressly cover indirect takings or state actions that are
described as tantamount to expropriation, suggesting that they are not in fact expropriations but merely something close or equivalent.

Some Suggestions about Regulatory Risk and Expropriation

So what does all this mean? When does regulatory action become a violation of international law? And is it the intent that any regulatory action that does violate international law be covered, even if it is not strictly speaking an expropriation?

Unfortunately, unlike other misconceptions about expropriation, this one may prove difficult to clear up. Certainly a start is to make policy language clearer that host government regulatory risk is completely excluded from expropriation coverage. Whether or not economic loss from host government regulations is expropriation, it should not be a part of expropriation risk unless the regulation is clearly designed to be expropriatory.

Some insurers now include language such as this:

This policy does not cover losses arising from any claim or dispute relating to any action taken by the Host government for the regulation of the [specify industry] or the Project, including without limitation any claim with respect thereto against [specify regulator], unless such action is expressly confiscatory in intent.

Insurers could then examine regulatory risk in isolation. Those choosing to cover some part of this risk could then specify in another coverage, such as regulatory taking coverage, exactly what they intend to cover. Perhaps a regulatory action that under international law is tantamount to expropriation will suffice. Perhaps it will not. Nevertheless, any coverage offered will necessarily need to distinguish between legitimate and illegal regulatory acts, which will remain difficult. In any event, avoiding the issue and perpetuating the misunderstanding is not a good approach.

Conclusion

All these misunderstandings about expropriation have at least three things in common. The first is an attempt to stretch expropriation coverage beyond its intended scope. Many insureds assume that expropriation coverage addresses all wrongful acts of the host government; insurers intend to cover a narrower set of enumerated
risks. Expropriation coverage was never intended to be a form of governmental “all-risks” coverage.

The second is the principle that political risk insurance should not put the insured in a better position than it bargained for. If an insured has entered into a contract providing for arbitration of disputes, it should be expected to arbitrate. If an insured has invested in a country with an ineffective legal system, it should expect delays in dispute resolution and enforcement of judgments. If an insured does business in a heavily regulated industry, it should expect regulatory changes that will affect its business.

The third is the need for improvements in existing political risk insurance policy language. Most political risk insurance coverages were written before the large international project financings of the 1990s. Many of the misunderstandings arise from oblique language taken from the London market, where parties may understand one another more through the course of dealing with one another than through specific wording. All of these misunderstandings could be mitigated by more direct and specific language in policy language. Whatever the source of these misunderstandings, insurers and insureds need to work together to address specific host government risks and create new coverages that work predictably for all parties.

Notes

118. Waste Management, Inc. v. United Mexican States, I.C.S.I.D. Case No. ARB(AF)/00/3, Final Award (Apr. 30, 2004).

Discussion of the Emergence of New International Property Rights and the Role of Political Risk Insurance in Project Finance

Symposium Panelists and Participants

The commentary and discussion centered on four issues: the differences between arbitral award coverage and denial of justice coverage, denial of justice as a separate coverage, the moral hazards for national and multilateral insurers, and comprehensive guarantees.

**Difference between Arbitral Award Coverage and Denial of Justice Coverage**

*Question:* What is the difference between arbitral award coverage and denial of justice coverage, from the point of view of the political risk insurer?

*Jenney:* Arbitral award coverage gives the insurer strong subrogation rights, by virtue of having a final finding and enforceable arbitral award. For this reason, arbitral award coverage is relatively easy for the insurer to offer. With denial of justice coverage, payment is made when the insured cannot get to the arbitral award because the government is thwarting it. Taking a claim to a government when the government has thwarted the arbitral process places the insurer in a significantly less beneficial subrogation position than taking a valid, binding, and final arbitral award.

**Denial of Justice as a Separate Coverage**

*Comment:* The position that Jenney proposes comes from the supply side and is very much underwriter focused. I come from the buy side and am client focused. This distinction is important, because at the moment the main question hanging over the marketplace is not
whether the industry can attract capital but whether it can continue to attract buyers, as many of the traditional clients are surveying their purchases of insurance and wondering if they are being well served. I would like to try and knock on the head this idea that denial of justice cover should be treated as a separate coverage. Breach of contract cover is not a viable policy unless it promises to honor the breach of contract claim if the host government thwarts the arbitral process. As for expropriation cover, it is difficult enough to understand the appropriate expropriation language; to then have an exclusion that takes away some of the expropriation cover by excluding denial of justice is completely unnecessary. Frankly, if this kind of exclusion starts appearing in some underwriters’ policies, brokers will simply point clients to an insurer who does not have that exclusion (and there will not be any problem finding insurers who do not have that exclusion). So the proposal to exclude denial of justice is a profoundly retrograde step.

**Jenney:** The point of any coverage is to cover; writing a bunch of exclusions does not get anybody anywhere. But the overriding point is clarity, and coverages, as now worded, are too vague.

Underwriters should offer denial of justice as part and parcel of their breach of contract policies. It may be right that it does not work well to carve out, and leave carved out, denial of justice coverage. But it also does not work well to just leave it implicit. So it is important to make explicit what was implicit, including identifying the precise steps the insured has to go through, in order to set some standards for what has to be done to achieve a valid denial of justice claim.

**Question:** I compliment Mr. Jenney for deconstructing and clarifying expropriation coverages for this sophisticated audience. But I question the “marketability” of this approach. Should we not be concerned that shopping for political risk insurance could become like walking into Starbucks for the first time to buy a simple cup of coffee and being presented with a bewildering array of choices. Are investors sophisticated enough to deal with this, and are they willing to pay three times as much for one coverage than another?

**Jenney:** One of the advantages of the building block approach is that the investor can buy plain vanilla coverage and stop there, because there is some clarity as to where it stops. So some investors do not need to buy the equivalent of the double decaffeinated, specially flavored coffee. The building block approach would facilitate not selling
people more than they want and selling the people who want everything exactly what they hope to get.

Moral Hazard for National and Multilateral Insurers

Comment from a representative of a multilateral institution: Wells’s assertion of moral hazard—whereby multilateral agencies that had claims agreements with host governments did not investigate the legitimacy of investment disputes sufficiently, but instead simply paid off the investors too “easily” because they could always recover their money from the host authorities—is ill-founded. Multilateral agencies do, as a matter of business, remind their shareholders that they have obligations toward the agency and that management’s expectation, as well as that of their fellow shareholders, is that decision making with respect to the payment of recoveries will ultimately be guided by enlightened shareholder self-interest. In this context, there is likely to be peer pressure among the shareholder countries on the board for them to right a wrong if, indeed, there was a wrong in the first place.

A further correction to the discussion of the moral hazard facing insurers is the fact that while one may get an agreement from a country to provide funds for recovery, it may take several years to do so. Moreover, whereas private insurers can quickly raise capital in the market, if international financial institutions find themselves in need of capital, it will take much longer to obtain it, underscoring the need to manage risks carefully.

Comment from an OPIC representative: The ease with which OPIC can recover funds from a foreign government after having paid out a claim may be changing. OPIC has a good record of having recovered on claim payments made, but a simple look at the record does not quite take into account how long it has taken in some cases to affect that recovery or the terms on which the recoveries have been made. Recently, in the Dabhol case in India, the only recourse that the U.S. government had was to file for government-to-government arbitration, under the intergovernmental agreement that OPIC has been operating under. This is the first time ever. So the “ease of recovery” may be a thing of the past.

Wells: In the paper, I was careful to refer to the perception of moral hazard. That perception is almost inevitable on the part of the host country, no matter how the insurer behaves. There is probably a stronger
perception in the case of the home country official insurer than in the case of MIGA, because in the case of the home country agency there is no shareholder representation by the country being affected. There is a concern on the part of some political authorities in the developing world—which may or may not match the reality—that the investor can put political pressure on the home government insurer to pay and there is no counterbalance on the other side of either costing something or the host country being able to make a defense.

With regard to allegations of corruption, the record shows that investment insurers did not engage in adequate scrutiny, at least with regard to foreign investors offering minority partnerships to designated friends of the regime in power in order to be awarded contracts in Indonesia. This is the subject of the book I am writing.

**Comprehensive Guarantees**

*Question:* There is a tendency for some clients now to demand comprehensive credit and political risk guarantees that are unconditional, a tendency for clients to ask the marketplace to create unconditional products out of products that were never meant to be unconditional. Political risk insurance or guarantees have traditionally had conditionalities attached, yet does it not appear that clients are now often looking for literal financial guarantees?

*Wells:* Such demands spring from a wave of large projects, large investments whose size is very great relative to the company. The company thus finds it harder to bear the risk, especially in activities in which the investor does not feel protected by providing some kind of special technology or access to foreign markets. Even though they may not intellectualize it this way, investors intuitively recognize the degree of their exposure and look for someone else to bear that risk.

It is quite impressive how investors have found ways to slough the risk off on someone else. Infrastructure investors want insurance against movements of exchange rates. They can get insurance against inconvertibility. As for insuring against currency movements, they can try to use the forward market, but this route is difficult for very long-term protection—not impossible, but difficult. So what some infrastructure investors did was to figure out a way to insure against devaluation in a more conventional framework. They write their power purchase agreements, for example, in dollars, in theory putting
the risk on the government of the country in which they are operating. But if there is a very sharp devaluation—which is what happened in Indonesia—the government cannot honor it. The contract is thus broken, and a claim could go right back to the insurers, who thought they were not offering devaluation insurance but, in fact, in the end offered a form of currency value insurance.
This Part 3 examines the evolution of private-public relationships in the investment insurance industry. The first paper, “The Future of the International Political Risk Insurance Industry,” is by Clive Tobin, Chief Executive Officer of XL Insurance. The second paper, “Perspectives on Private-Public Relationships in Political Risk Insurance” is by Toby Heppel, of the FirstCity Partnership Ltd., a leading Lloyd’s broker.

The insurance market consists of a broad array of very different kinds of risk transfer businesses. Hence any projection of future trends, argues Tobin, has to be assessed in light of the difficult conditions and large losses that have afflicted the whole insurance industry in the past decade.

During the past decade, the U.S. non-life insurance industry has received annual returns averaging 6.7 points lower than the cost of capital, according to the Insurance Information Institute. In 2002 there were early signs of a turnaround, but U.S. property and casualty insurers still managed to achieve a positive return of only one percent, about half of what could have been earned by investing in one-year Treasury notes.

By 2003 the return rose to 9.4 percent, still less than the 12 percent average annual return for the Fortune 500. During 2003 only four property and casualty insurers received a return on
equity of more than 13 percent, the average cost of capital for the prior 10 years. As a result, there have been significantly more credit downgrades than upgrades in the insurance industry in recent years, and credit quality has become more important than ever before.

In the political risk segment of the insurance industry, there has been a general perception that this class of coverage is countercyclical in comparison with the overall insurance market. While other parts of the industry have recovered since 9/11, there has been a significant contraction in capacity in political risk insurance. After reaching a peak during 2000 and early 2001, per risk capacity from the private sector fell back below $1 billion in 2002, with perhaps less than 50 percent of capacity available for a 10-year exposure in 2004 compared with 2001. In 2004 both insurers and reinsurers have been rebuilding their capabilities. Among political risk coverages, trade finance products—in particular, obligor-default coverage (contract frustration and trade credit insurance)—have received emphasis.

As for the pricing of political risk insurance, private insurers are driven by market rates, whereas public insurers use more formulaic approaches. As a consequence, bank margins have been a key to private sector pricing, especially for obligor-default products, with a 50 percent drop in overall emerging market bond spreads since the last MIGA-Georgetown Symposium two years ago. These spreads are changing fundamentals in managing capital and the pricing of insurance, however; suggests Tobin, historically, recovery of large losses experienced by existing companies could be priced into rate increases going forward. Today new capital and capacity, in the form of new companies, can be effected so quickly that prices at the level of duration required to replenish lost capital and provide adequate returns to existing insurers will be dampened by the lower pricing needs of new capital.

Under conditions of tight capacity, XL pays particularly close attention to relationships—who is being insured as much as what or where. Among the most important attributes of insurers, reinsurers, and coinsurers are the ability of all parties to anticipate potential problems and deal with them in the structuring of transactions at the beginning and the willingness of all parties to deal constructively with difficulties should they later arise.
Private insurers have increasingly appreciated the value-added of working with the public sector. Public-private cooperation has been enhanced by the greater willingness on the part of the public sector to seek close private sector relationships, by relaxation of “national interest” constraints, and by greater flexibility on the part of the private sector on confidentiality and on taking development issues seriously. Both sides have greater experience in working together on claims, leading perhaps toward commonality of approach. The Argentine crisis proved the value of joint ventures among insurers, especially since Berne Union members received special status.

Through 2000 some insurers’ general reinsurance of whole programs could be leveraged to include significant amounts of political risk insurance coverage. Beginning in 2001, however, reinsurers began to pull back, reducing capacity, shortening tenors, and restricting some types of coverage. Most participants in the political risk insurance industry purchase some kind of reinsurance protection. Net line carriers, however, have obviously been less affected by the tightening of the reinsurance market.

Looking to the future, there may be some improvements in the reinsurance market and therefore some easing on tenor and conditions, according to Tobin. The sharp contraction in private infrastructure investment—two-thirds less in 2002 than in 1997—appears to be in reverse, increasing the demand for insurance in this sector. However, insurers will need to avoid the calamities of the recent past. To achieve this, he argues, insureds need to be clear about what they are buying, and insurers need to clearly understand what they are (and are not) covering.

If it proves difficult to achieve clarity in insurance contract language, suggests Tobin, another alternative in the future might be some form of a derivative. With a derivative, a claim is triggered by an industry event and not by requiring an insured to prove it suffered a loss. XL would be receptive to hearing what others think of derivatives as a concept in this regard.

Just as MIGA hopes to expand its guarantee coverage in low-investment regions and postconflict situations, the private sector may want to contemplate greater insurance offers in these areas, perhaps working hand in hand with public insurers. For XL, concludes Tobin, the case for private-public partnerships
is strong. It expects to maintain its key existing partnerships and to build new ones.

To assess the evolution of the relationship between public sector and private sector political risk insurers, comments Toby Heppel, of the FirstCity Partnership Ltd., it is important to note how public and private political risk insurers differ. The first important difference is in the motivation behind their actions. Public sector insurers have a public role to fulfill that is reflected in who is eligible for coverage, be it a national firm in the case of a government insurer or an investor of a member state investing in another member state in the case of multilateral agencies. Most public sector insurers also screen for project characteristics as they relate to the investment’s environmental, cultural, social, or long-term developmental impacts. Usually, only new investments, not preexisting ones, can be insured. Eligibility for coverage may be affected by the amount of home country goods and services that will be used in the insured project. National agencies may grant or withhold coverage in accordance with foreign policy considerations. National interest may also, in the perception of some, suggests Heppel, condition the level of effort put into pursuing recoveries.

The private sector does not have similar eligibility criteria. Private insurers are free to pursue projects that may be forbidden by national or international sanctions. They may condition their provision of coverage on social and environmental criteria, if only because projects that are likely to stimulate adverse attention may be riskier than others. The main purpose of private sector insurers is to make money, whereas public sector insurers have only the requirement not to generate losses that taxpayers might have to make good on.

The second important difference between public and private insurers is in their operations. Traditionally, private sector insurers have had the reputation of being simpler and quicker than the public sector, but, according to Heppel, there has been some convergence. Public insurers have made efforts to streamline their processing and approvals. Private insurers are now taking longer to analyze complex deals, including pipeline or telecommunication projects that involve multiple countries.

Another operational difference can be found in pricing strategy. Public sector insurers tend to price according to their
appraisal of the actual risk; private sector insurers charge on the basis of market conditions. For private insurers, when the limits of capacity are approached, the price rises independent of the risk.

The creation of MIGA in the late 1980s was met with some complaints in London that it created a tax-funded competitor, observes Heppel, notwithstanding MIGA’s commitment to complement rather than compete with the private sector. There was little understanding early on that private insurers could use MIGA to enhance their portfolios.

Initially, the tenors available in the private sector were generally too short (three years) to compete with the public sector. But in 1995 Lloyd’s offered seven-year coverage for a power project. The next year AIG duplicated the seven-year offer, then offered 10 years and 15. Once the private sector began to offer tenors as long as those public agencies offered, a new round of criticism emerged that taxpayers’ money should not be used to support political risk insurance by export credit agencies or multilateral agencies.

That criticism is flawed, in Heppel’s view. As Clive Tobin points out, the political risk insurance industry is cyclical, and during periods of crisis the public sector may play the important role of insurer of last resort. Moreover, through partnerships with public sector insurers, the private sector gains access to business it would not otherwise encounter, to mitigation that may reduce the likelihood of loss or increase the likelihood of recovery (the so-called “halo effect”), and to specialized kinds of information. From the public sector side, private insurers bring a depth of underwriting experience, novel ideas for coverage and contract language, and new techniques for administering and servicing portfolios.

There have been some allegations of private insurers “poaching” projects from public agencies and public insurers aggressively pursuing projects the private sector wants to underwrite. There are also practical difficulties in public-private cooperation. Who should lead on claims negotiations? Can public sector agencies give up their 100 percent subrogation rights when private sector insurers are also involved? Does the public sector have to be made whole before private insurers receive compensation? Is there a duty to share all
information among all insurers? Can any one insurer act unilaterally, even if the action hurts other insurers? Most coinsurance agreements between private and public sector insurers, notes Heppel, simply pledge “best efforts” to respect each other’s rights, share information, and consult on how to proceed in the event of a loss.

Perhaps the premier model of a coinsurance agreement between public and private sectors, in Heppel’s view, is MIGA’s Cooperative Underwriting Program (CUP). The CUP allows private insurers to take on some of the same status as MIGA from the perspective of the host government, while MIGA commits itself to work on their behalf and share recoveries proportionately. Under the CUP, private participants retain the ability to take action on their own, but the incentive structure is for them to remain part of the team.

Public-private cooperation can also come with the public sector offering to reinsure a portion of a private insurer’s portfolio (treaty reinsurance). This allows the ceding company to manage its exposures with greater flexibility. The reverse can be found in MIGA’s reinsurance treaties with Ace and XL.

There are also possibilities for reinsurance of single transactions (facultative reinsurance) by private and public sector actors. The players have to be cautious, however, about adverse selection (partners trying to shift off poorer risks and maintain hold over better risks).

Overall, the private sector has learned that the actual experience of working cooperatively with the public sector yields benefits that far outweigh the difficulties of doing so, argues Heppel. Public-private cooperation “is here to stay.”

Nevertheless, exactly how public-private cooperation might evolve depends on one’s scenario for the future. Trends and market conditions may continue roughly as they exist today. Alternatively, there may be simultaneous crises of grand proportions that force major contractions in private sector capacity. New techniques for managing portfolios of risk or expanding capacity, such as credit default swaps and securitization, might fundamentally alter the parameters for public-private cooperation as time unfolds.

Heppel acknowledges that in some quarters there is demand for currency devaluation coverage. Whether written by public
or private insurers, or by some combination of the two, such coverage would have to be financed by premiums designed so that the issuers do not underwrite themselves into a catastrophic loss. Heppel suggests that it is probably better to go down to the betting shop for this than to try to cover it with insurance.
The Future of the International Political Risk Insurance Industry

Clive Tobin
Chief Executive Officer
XL Insurance

I am delighted to contribute to the symposium, at a time when the political risk insurance community has been through some of the most challenging times imaginable. When this symposium was last convened, two years ago, the terrorist attacks on the United States were still vivid in the memory, Argentina was in the relatively early stages of a catastrophic economic situation, there was a global investment downturn, and major corporate bankruptcies were headline news. Overall, there was a great deal of uncertainty as to what the future held for our industry. Two years later, some of the imponderables affecting us have been resolved, and even where they have not, we are able to put them in perspective.

I would like today to take a look at how the political risk market has been affected by the events of 9/11, to take a headline view of how relationships between the private and public sector carriers have developed, to review developments in the reinsurance of political risk, and to close with a view of how things look for our industry in the future.

Before I provide my perspective on these issues—and avoid, I trust, any charge of advertising—I think I ought to clarify the position from which I am opining. Established in 1986, XL is a major global provider of risk mitigation tools by way of insurance, reinsurance, and financial products. The group, headquartered in Bermuda, has total assets of more than $40 billion. In 1998 we wrote premiums of $1 billion from two countries; in 2003 we wrote premiums of
$5.3 billion from more than 25 countries. From this perspective, I hope I will be able to explain how I see the political risk insurance sector as a subset of a rapidly growing and broad whole.

Throughout this period, political risk has been a core XL product. We have been one of the world’s major capacity providers, and I hope that we have demonstrated a commitment to the product in all its manifestations. We write political risk through our XL Insurance global practice, headquartered in London; through our 50 percent interest in our joint venture with Ace, Sovereign Risk Ltd.; through XL Reinsurance; and through XL Capital Assurance, our AAA financial guaranty company, which deals with exposures such as emerging market future flow transactions. We are honored to be MIGA’s oldest cooperative underwriting program partner in the private market through our London operation, and, along with our neighbors at Ace, we also provide MIGA with quota share reinsurance.

Recent History of the Political Risk Sector

I think it is appropriate to put the recent history of the political risk sector into the context of what has been happening in the wider world of general insurance. Essentially, the insurance market consists of a wide variety of very different types of risk transfer businesses. Some of these, such as marine coverages, have been around for hundreds of years; others, including private sector political risk coverage, have been around for only a few decades. Some types of business, such as property insurance, account for a relatively large proportion of the overall dollars spent on insurance; niche products represent a smaller proportion.

Cyclicality is a common feature of the different product lines, and theories abound as to the drivers and determinants of these product cycles. What is universally accepted is that in most classes, private sector insurers are there to earn a return on the capital invested in their businesses. When returns in one risk sector are relatively low, the free market should see a flow of funds toward more beneficial investment in the form of other risk areas.

The problem for the general insurance market has been the close connection between the cycles in different lines of business. Before September 11, the U.S. property and casualty industry—a good barometer for general lines insurance—was more or less at the bottom of the curve in terms of rating dynamics. According to the Insurance Information Institute, during the preceding decade, the U.S. non-life insurance industry missed its cost of capital by an average of
6.7 points each year, an extraordinary statistic. Although there were signs of change during the first half of 2001, the insurance market started in the foothills of the up-curve to a point nearer the summit as a result of the momentous events of 9/11 and the catastrophic losses that resulted. Due to those losses, the hard cycle provided insurers with what were—in theory at least—the best market conditions in recent memory and a chance to replenish the coffers in the succeeding years.

That was the theory. What has happened in practice? According to the Insurance Information Institute, in 2002 the U.S. property and casualty industry obtained a heady 1 percent return—precisely half the return that could have been earned from one-year Treasuries. In 2003 the return rose to 9.4 percent. The 2002 numbers were obviously affected by fourth quarter charges from 2001; the 2003 numbers are thus a good measure of “clean” underwriting conditions. Although the 2003 results were very much an improvement, it is important to note the Fortune 500’s return of more than 12 percent for the same period. Going back to the cost of capital, the average for the decade from 1992 was about 13 percent. Further evidence of the context in which property and casualty insurers found themselves is that in 2003 only four achieved a return on equity of more than 13 percent, in what is likely to be the peak of this cycle. It is therefore not surprising that in the past three years, our industry has seen significantly more credit downgrades than upgrades, and credit quality has become more prominent than ever before. Insurers can also no longer operate with cash flow underwriting and subpar returns on the basis of playing catch up when the hard market returns. As the events of 9/11 demonstrated, new capital moves into the industry so quickly that go-forward pricing will be dictated by new as well as existing players.

The first half of 2004 was very good for property and casualty insurers on the whole, with the combined ratio of claims and expenses at its best in almost 20 years. Then came the hurricanes, which wiped out the first half of the year’s surplus. We have already seen the signs of market softening in a number of areas, including property, transportation, and energy. A number of us within our industry are wondering just how much downside there will be for this end-of-year renewal season. Certainly, the extraordinary hurricane activity in the United States should halt the decline in the energy sector, for example, but we expect softening elsewhere.

So what has happened to the political risk sector over the same period? One of the attractions for general lines insurers has been the perception that, to a certain extent, the class is countercyclical with
the general insurance market. By that yardstick, it follows that times of plenty in the general market are ones in which capital providers concentrate their efforts on these classes, in an effort to enjoy the up-cycle benefits before the next downturn occurs. This is undoubtedly what occurred in the direct and reinsurance markets since 9/11, and we have experienced a significant contraction in private sector political risk capacity.

After doing some comparisons with our friends in the broker market, we have been able to analyze how capacity has changed over the past three years in the private sector. By common consent, capacity reached its peak during 2000, and even during the first part of 2001 capacity had begun to ease back, due to Lloyd’s reinsurance issues (more on this in the next section). Let’s put that last remark in perspective, though: at the time, it was still possible in theory to assemble well in excess of $1 billion of capacity on a single investment risk in the right conditions. The year 2002 witnessed a sharp contraction in investment insurance capacity, and the per risk theoretical limit fell back to below $1 billion. However, aside from the pure quantum of possible risk limits, one of the most significant changes was that risk tenors were cut back severely. One broker estimates that compared with 2001, even today less than half of capacity is available for a 10-year exposure. This obviously has major implications for both insured entities requiring long-term coverage and public and multi-lateral insurers needing matching coinsurance or reinsurance coverage to dovetail with their own writings. Following further declines in capacity during 2003, there has been something of a revival in 2004. We see evidence that both direct and reinsurance underwriters appear to be rebuilding their capabilities at a time when the general market is softening. So what we have seen is a direct link between what has been happening in the mainstream insurance markets, the reinsurance market, and the effects on private sector political risk.

As to the question of other dynamics affecting private sector political risk insurers, the relative stagnation in cross-border lending and investment led to a reduction in overall demand for political risk products. As a result, new deals were relatively scarce, and the private market saw instances of existing investors cutting back on their political risk insurance budgets to pay for material price increases on coverages elsewhere in the corporate risk management portfolio, such as property, casualty, and professional indemnity.

Within the private political risk sector, the mix of business also began to change, as the trade finance subset continued to hold its own with due emphasis on obligor-default products (contract frustration
and trade credit insurance policies). So were insurers fortunate that at a time when their ability to deliver policies had been adversely affected, that there wasn’t the demand there to expose this situation? Yes and no. Yes, because the unique circumstances of 2001—not just the events of 9/11—put us all under strain. No, because it may well have been that supply-side drivers, had they existed, might have reignited the provision of greater political risk capacity.

We have addressed capacity and touched upon coverage, but what about pricing during this period? You are well aware of the differences between public and private sector rating and the fact that private insurers need to price in accordance with market rates rather than formulaic guidelines. A number of private sector insurers have commented on the presumption from capital providers that, in the dark days of 2002, there were so many negative risk factors in the portfolio that rates must have increased in multiples. Well, that wasn’t the case—and the private sector is well aware that rates have been on a downward track over the past 24 months or so.

This illustrates the other emerging feature: namely, that bank margins have become one of the dominant drivers of pricing in our market, certainly with respect to obligor-default products. Emerging market bond spreads are overall about half what they were at the time of the last symposium. The effect of a large pool of bank capital chasing a smaller number of deals, combined with a gradual improvement in the overall perception of emerging market risk, has had obvious results. Time will tell how rising U.S. interest rates will affect things in future.

**Relationships between the Public and Private Sectors**

Toby Heppel’s paper explores how relationships between the private and public sector insurers have evolved, so I will not describe this area in great detail. I would, though, like to give a private sector insurer’s viewpoint on how we regard such relationships today. Corporately, we are very much a “relationship” insurer; we care about whom we are insuring as much as what or where. Across many different classes, experience and intuition have shown us the importance of the parties we cover, and nowhere has this been more important than in the political risk area. Previously, I alluded to tightening capacity. We, and many of our market peers, will reserve scarce capacity for our relationship insureds and reinsureds. We have also learned that when the going gets tough, it is essential to have backed those insureds, reinsureds, and coinsurers that have two fundamental
attributes: the ability to structure transactions in the first place, so as to maximize up-front risk mitigants, and the ability and the willingness to sort problems out, should things still go wrong.

The Argentine crisis provided a very appropriate testing ground for these qualities, and I have to say that our tie-ups with the public sector were not found wanting. The value of joint-venturing with other insurers that bring real added value into play was amply demonstrated. The Argentine crisis also demonstrated the value of Berne Union membership, and I think our Sovereign joint venture was able to utilize its partners’ membership to their distinct advantage.

Having been through the furnace of a country crisis, I am sure that we and our peers in the private sector appreciate the added value of the public sector. I do hope that our public sector brethren take the view that the benefit has been mutual. Although private insurers could not add value in terms of things such as transactional exemption from regulations, I hope that the ability to contribute creative thinking to joint problems was in evidence and will remain so when the next problem engulfs us.

Argentina and Venezuela have been learning processes, and I would be interested to learn if the public sector perspective is the same. In the final section of this paper, I forecast what public sector relationships may look like in the future. In the meantime, I should mention that a few factors have helped increase the common ground between the public and private sectors. These include:

- The relaxation of rules relating to national interest by the public sector insurers.
- The increasing flexibility and willingness of the public insurers to work with private sector counterparts.
- The growing acceptance by the private sector that confidentiality is not a fundamental prerequisite.
- The embryonic forays of the public sector into taking risk from private sector insurers by way of reinsurance after the event.
- The growing acceptance by the private sector insurers that development issues are important.
- Increasing experience working together on claims and perhaps an emerging commonality of approach.

The reinsurance of political risk is a mysterious science. I previously mentioned the marketplace before the events of 9/11. Essentially, Lloyd’s syndicates were tied to the fortunes of the general
reinsurance market, as several major players bought their protection as an integral part of their general reinsurance (or “whole-account”) programs. The great advantage of this arrangement was that in a soft reinsurance market, large amounts of coverage could be obtained very cost-effectively, and a form of leverage was thus applied. The buyers’ market in reinsurance applied until the end of 2000, but by 2001 the market was beginning to turn, and reinsurers began to restrict the amount of political risk coverage they were willing to provide. Suffice it to say that 9/11 and the Argentine crisis did not have a wholly beneficial effect on things for reinsurance buyers. Thus by the start of 2002, the reinsurance market had turned, and the following features became established for the next three years:

- Restrictions in the amount of political risk capacity available, as reinsurers concentrated on maximizing their returns from the “traditional” classes.
- Severe restrictions on political risk coverage, including a pull-back on policy tenors and limitations on obligor-default products.
- The virtual abolition of political risk from Lloyd’s whole-account reinsurance programs.

These developments have had a direct feed-through to the private political risk insurance market, in the form of less overall capacity, restrictions on coverage, and policy period reductions. Public insurers have been indirectly affected by the changes, as the ability of the private sector to support their risks has deteriorated. Some major political risk insurers are net line carriers and have been less affected by reinsurance issues, but most players in the industry are purchasers of some sort of protection. As direct insurers have been client focused, reinsurers have concentrated their favors on their key cedants, so it is undoubtedly the case that the rich have gotten richer and the poor poorer.

Another feature of the political risk world that has been exacerbated by the reinsurance situation is the concentration of exposure. The private sector is made up of about 30 significant entities, with a high degree of correlation and concentration of risks written. Thus reinsurers can be ceded a very similar portfolio of countries from the insurers they protect. Absent perhaps regional strengths, there does not appear to have been great opportunity to provide dispersal and differentiation of risk. This has further reduced the ability of the reinsurance market to satisfy the demand of all the direct players.
At XL we formed our company based on net line underwriting of excess liability coverage back in the 1980s, and that appetite remains. We look to purchase cost-effective, responsive reinsurance where appropriate, but we do not regard ourselves as beholden to the reinsurance market. Sovereign Risk remains a net line carrier, consistent with the approach we have adopted since its formation.

**What Does the Future Hold?**

What does 2005 hold for political risk reinsurance? Although the hurricanes have probably prolonged the residual hardness in the general reinsurance market, we see signs of optimism for political risk cedants. We have already mentioned the apparent paradox between market cycles, and a softening general market is usually good for political risk. We think there could also be some relaxation of the very tight grip reinsurers have had on the class, and we might expect to see some easing on tenors and conditions. Undoubtedly, though, reinsurers will attempt to concentrate their capacity on the best direct writers, and it remains to be seen just how widespread the benefits of any reinsurance improvement will be. From a cedant’s point of view, it should be noted that the flight to quality works both ways, so that the supply of capacity from some quarters might not be taken up. Well-known industry analyst and commentator V.J. Dowling has recently opined that fewer U.S. reinsurance buyers will be willing to go below A-rated carriers, certainly on longer-tail business. This trend reflects the legacy of the past three years, when nine major reinsurers stopped writing and either failed or are in run-off. Reinsurers have suffered concentration problems, which continue to be a major issue. We certainly feel that there is scope for further innovation in the means by which country exposures are reinsured, and we very much hope that there may be developments in this regard by the time of the next symposium. By the time of the next symposium, we may even have evidence of the utilization of the alternative risk transfer or bond markets to help in this regard.

I would like to dust off the crystal ball and conclude with the easy business of predicting what the future holds for our industry. Political risk capacity is making a comeback, and there are good grounds for taking the view that this trend will continue in the future. As far as investment is concerned, when we met in 2002, we were in something of a trench, and both lending and FDI were materially lower. Today all trends seem to point one way, and that is up.
We are already aware that the amount of investment needed in emerging markets means that there is catching up to do, and demand can only increase. This demand also coincides with the overall risk factors in global emerging markets looking better. We are seeing the continuation of improvements in legal and regulatory regimes that are more investment friendly (although there are countries in which this has not happened). The spread of regional integration, and—last but not least—improved credit ratings also act as a spur to investment and reduce risk costs.

We expect this upward curve to continue, but I think our industry needs to examine some of the assumed detail behind the general trend. Yukiko Omura, who spoke at the Chatham House conference earlier this year, made some very interesting points about the differentiation within emerging markets’ investment:

- There is a definite distinction between emerging markets. China alone accounted for more than 40 percent of total FDI during 2003. Conversely, Africa, the Middle East, and some central Asian economies witnessed either stagnation or a net decrease in investment. As Ms. Omura said, “the pie has been shrinking—and within the pie, the slices are increasingly inequitably distributed.” She also noted that 60 percent of all current emerging market FDI goes to five countries: China, Brazil, India, Mexico, and the Russian Federation.

- Across industry sectors, an extremely varied pattern exists. The service industry has grown strongly in some countries, but infrastructure has seen a marked fall in its share of FDI flows. The amount of private infrastructure investment fell by two-thirds in 2002 compared to 1997.

- The scale of investment needs to be reappraised, and small investments need to be encouraged.

- Geographically, MIGA is keen to expand the amount of guarantee coverage into low-investment countries and to make a push in postconflict countries.

Given these investment trends, what are the implications for insurers of cross-border risks? Three are worthy of note:

- In regard to geographical differentiation—or the lack thereof—I already mentioned concentrations of country exposures, and the “big five” countries are ones in which various players have had capacity problems at one stage or another. We need to
work out ways to accommodate risks in the larger host countries and to deal with the concentrations of accumulation that result. From the perspective of risk accumulation, the desire to spread the range of countries looks like a good thing indeed.

- The need for more infrastructure investment—and thus political risk insurance—is noted, and we need to plan accordingly. The problems in the power sector in particular are widely known. Insurers and insureds need to contemplate how to reconcile the need to cover investments and avoid the pitfalls of the recent past. Certainly, the private sector insurers are somewhat wary of the sector overall.

- We in the private sector are willing to look at new demand in a broader range of countries and hope that we can be brave enough to step up to the plate. In some countries the involvement of an appropriate public sector carrier may be a fundamental prerequisite.

With capacity for political risk in the private sector continuing to increase, I think this is the best possible demonstration of commitment to the class by capital providers. The shocks to the system have obviously been felt, but the specialist operators—small, medium, and large—have generally been consistent in their involvement throughout. This point is very important, because if insureds or public sector partners are possibly concerned about the vicissitudes of market cycles and the supply of capacity, it looks very much to us that the private sector marketplace has established a permanent niche in the specialist products sector, and I expect this position to continue.

As far as the products we offer, subsequent papers will deal with the issues in some detail. However, comments on several points may be worth making. First, the effect of the recent investment climate has meant that, in the private sector at least, there has been a concentration of obligor-default risks, both public and private status; insurers would welcome the balancing effect of more investment exposure. Second, we are all aware of the differences of opinion between insurers and insureds that have occurred in some cases over the past few years, and this is obviously of concern to both parties. It is vital that insureds know what they are buying and that insurers are clear as to what they are—and are not—covering. Investment risks are often necessarily complex, but we must reduce the uncertainty in insurance products before deals are done. One thing is very clear: the amount of contractual exposure within investment risks is unlikely to fall, and insurers need to appraise and price these exposures accordingly.
As far as XL is concerned, the case for private-public partnership is a done deal. We are firmly committed to our key existing relationships and want to build others. I think it is appropriate to view the requirements of the insurance-buying community as a joint challenge, and I am confident that, with the best endeavors of all sides and the harnessing of the respective talents, we can accomplish the tasks ahead.

I hope that my viewpoint reconciles with your own appraisal of where things stand and where we go from here. XL is proud to restate our commitment to this unique class of business. The political risk market has, I think, come through the turbulent times of the past three years, and—although I don’t want to tempt fate—is looking in pretty good shape. I think that buyers and sellers can look forward with a degree of cautious optimism.
The subtext to the title of this paper asks how the relationship between the private sector and the public sector is changing and what that relationship will be in the future. Critically, it looks for a perspective on how this relationship, like all relationships, is occasionally tested. I would like to address how tensions can sometimes arise and how they can be fixed.

This aspect is of particular interest to me personally, because a key role of an insurance broker is enabling and nurturing relationships. These are, of course, purely business relationships, but what sets insurance apart from so many other lines of business is the extent and depth of the human interaction and reaction between the parties that trade with one another. This is hardly surprising when one remembers that the overriding principle on which the business of insurance is founded is that of *uberrima fides*—"utmost good faith." This is presumed to be present in all insurance dealings, not just political risk insurance, but the simple presumption of its presence does not prevent one or both parties from occasionally harboring doubts or misinterpreting each other’s actions.

I would like to approach the subject in the following stages:

- The origins of the private and public sectors: their essential differences in role, motivation, and operational approach.
- The revolution of the 1990s: convergence and competition
The developing partnerships: progress and pitfalls
A look at reinsurance
Where next?

Origins of the Sectors

When one talks of political risk insurance, one should establish what practitioners in the business mean by the term and examine the structure of the marketplace, what drives it, and how it evolved. After all, one cannot look at how relationships are changing without examining how they developed in the first place.

As in so many specialist areas of business, practitioners in the world of political risk insurance, in both the private and public sectors, have created a language of their own, in which similar sounding words and phrases have different meanings. Here at the MIGA-Georgetown Symposium, for example, I suspect that most people apply the term pretty much exclusively to the insurance of cross-border investors and project financiers against the sovereign risks in the country in which the project enterprise is located—which is to say, investment insurance. Those who are familiar with the class will also understand what the basic coverages are (Expropriation, Nontransferability, War and Political Violence, and Breach of Contract).

It is true that some insurance providers, both in the public and the private sectors, focus exclusively on the provision of investment insurance. However, if you mention the term political risk insurance to a broker, or to insurers in the London market, one finds that it is understood to refer to a far broader range of product lines. It is not just about investment insurance for project owners or lenders. The term also embraces trade risk—cover for exporters or importers of goods and services from or to developing countries. Some insurers call this coverage contract repudiation, others call it contract frustration; official agencies refer to it as export credit insurance. Confusingly, this coverage is not the same as breach of contract coverage in an investment insurance program. Some political risks insurers also provide cover for “wrongful calling” of “on-demand bonds” (also known as “unconditional bonds”), which are posted to support a contractor’s performance of his obligations. Other products are also in this class of business, including political risk insurance packages for mobile assets, such as plant and equipment a contractor is using on a project overseas.

The private political risk insurance sector has evolved to provide a broad range of products to meet the diverse demands of its
customers, far broader than that offered by the public sector providers. Some private insurers may specialize in only some of these political risk insurance products, while others offer them all.

It is tempting to believe that the public and private sectors are two species occupying entirely different worlds, performing entirely different roles, and that any overlap in their functions is accidental. Indeed, for many years this was the case. The public sector has been providing political risk insurance since 1919, when the British Export Credit Guarantees Department was created. Other countries followed suit, albeit slowly. In 1934, when the Berne Union was created to provide a forum for official export credit agencies, it had just four members. In the years that followed World War II, the number of official export credit agencies providing political risk insurance increased. Indeed, the past 20 years have seen a substantial increase in the number of public sector insurers as the governments of new autonomous states in the former Soviet Union and the Balkans established their own agencies, and new multilaterals, such as MIGA and the Islamic Development Bank, began to write political risks.

In the normal scheme of things, there should have been no room for private sector insurers in this area. Why should there be? After all, conventional insurance in other classes of business is usually written on an annual basis, and in any case, all private sector insurers were subject to restrictions that hampered their involvement in the kind of products that the official agencies were offering. Not least of these was the war exclusion agreement, which prevented them from insuring one of the principle political causes of loss.

I quote from an article that appeared in the *Financial Times*: “the development of private political risk insurance is due to the inability of investors to obtain from official agencies cover for all types of investment and in all countries. Private insurance is also available for projects financed or supplied from third countries.” That article appeared in 1974. Thirty years ago political risk insurance in the private sector was in its infancy. It was born at an interesting time. Developing nations, many of them recently independent, were asserting their sovereignty and seeking greater influence over domestic and global economic affairs. Expropriations of foreign-owned business had occurred. The oil crisis of 1973 was reshaping the outlook for the global economy. We were five years away from the overthrow of the Shah of Iran and still in the depths of the Cold War.

We can gauge a number of things from this short extract. First, the official agencies were perceived to be failing to provide a product that their customers needed, at a time, perhaps, when their
customers needed it more than ever before. This was not because the official agencies were all that new to the game. As we saw earlier, the public sector was already well established. As the Financial Times article indicates, one problem was that the official agencies, quite justifiably, would not cover those portions of a project that were sourced from countries other than their own. However, this failed to address the fact that international business was beginning to become multinational.

Second, where a gap appears in the market—and insurance is very much a marketplace—someone will step in to fill it. The perceived shortcomings of the official agencies during the 1970s prompted customers to turn to their insurance brokers to see if the private sector could provide a solution.

In those early days, though, there were few areas in which the private sector was equipped to compete with the public insurers. For example, no private sector insurer could write a policy for more than 3 years duration, while the public sector could go out to 15, perhaps 20 years. No private sector insurer could provide insurance to a project financier lending to a foreign enterprise or insure against land-based war damage. The private sector had very limited capacity compared with what it has today and in that respect lacked the resources available to the public sector.

Yet the private sector was able to provide a service and product range that, at that time at least, the public sector could not. The private sector’s product line was far less convergent with the public sector than it is today, and it lacked the institutional solidity that remains the hallmark of the public sector. Nevertheless, it provided insurance buyers with an alternative they were prepared to purchase.

In order to chart the process by which the private sector came to encroach on the public sector’s turf, one should perhaps pause and look at the essential differences between these two species of insurer. There are two chief areas in which they differ.

The first is the motivation that drives each of these sectors. The public sector has a public role to perform, and every export credit agency or multilateral operates under a mandate from its governing authority. This inevitably leads to the requirement that the policyholder and the policyholder’s enterprise that is to be insured be eligible for cover. Multilateral agencies have no such national restrictions. Some, such as MIGA, make their coverage available only to investors domiciled in a member state and investing in another member state; others cover policyholders in member states that are working in nonmember states. Most public sector insurers have
restrictions on the type of project they will insure, following rules concerning the ethical, environmental, cultural, or social impact. MIGA’s key driver is that insured projects should be consistent with the World Bank’s mission to combat world poverty, so that, in addition to the criteria previously mentioned, there must be clear, long-term developmental benefits from the project in the host country. Another criterion followed by most public investment insurance providers is that coverage may be purchased for new investments; preexisting investments are not eligible.

The Financial Times article shows that in the 1970s the ability of the public sector to provide insurance support was dictated by the content of goods and services to be used in the insured project that emanated from the export credit agency country. This “tie” is less rigorously applied than in former years, but the implied mandate to act in the “national interest” led to the view, in some quarters, that public sector agencies presented their governments with a useful conduit for the application of foreign policy initiatives and the perception that the rigor with which recoveries were pursued in some contexts was less than in others.

The private sector, broadly speaking, has no eligibility criteria. It is receptive to any project or venture that is lawful and where they are not prevented by sanctions from participating. However, “receptiveness” is not the same as “appetite,” and private sector insurers have no difficulty rejecting proposals if in their perception the risk is unsustainable. It is also true that private sector insurers are not guided by the potential for environmental and social impact, but it is now received wisdom that projects that attract controversy of that kind are riskier and frequently make for bad business.

The critical motivator of the private sector is simple. Its mandate is not derived from the national or supranational interest or any mission statement. Its mandate is to make money. That is what drives all commercial insurance, including political risk insurance. I refer back to Clive Tobin’s paper on the cyclical nature of the insurance and reinsurance industries and how insurance capacity is periodically drawn in and out of those classes of insurance business that present the best return on capital at a given time. If political risk insurance represents a profitable part of an insurer’s portfolio, it will be sustained and resourced; if it consistently fails to produce returns, it will not. Whatever other margins between the private and public sectors become blurred and whatever other changes take place in the future so as to bring convergence between them, the motivation of pure profit will always be a critical difference. Of course, public sector
insurers are under a duty not to be a burden on the taxpayer, and many of them contribute handsome checks into their governments’ treasuries every year, but maximizing profit is not their primary aim.

The second difference between the two sectors is operational. This is less true now than it once was, but it remains a fact that buying political risk insurance from the private sector is still simpler and quicker than buying it from the public sector. In addition, it is often said that private sector insurers are perhaps quicker than the public sector to respond flexibly and to adapt to the particular needs of the policyholder in a given situation. Curiously, over the past few years there has been convergence in this area. Many public sector insurers have made great efforts to simplify their procedures and speed up their underwriting processes. At the same time, in the private sector, given the increasing complexity of the risks they are asked to underwrite, brokers and insurers are taking longer than they once did to present and scrutinize projects for which cover is sought.

We are also seeing a more flexible approach in the public sector when faced with projects with peculiar characteristics. For instance, some projects may involve several different countries, a loss in any one of which would jeopardize the entire venture. An example of this is a pipeline project or a telecommunications cable. Ten years ago one of the biggest fiber-optic cable projects ever undertaken, spanning 24 sovereign jurisdictions, had to be insured in the private sector, because no public agency was operationally equipped to underwrite a multicountry project. Today one would expect the public sector to lead the insurance on a risk of that sort.

Another essential operational difference between the two sectors is in risk pricing. By and large, public sector insurers fix their premiums according to their perception of the actual risk involved. The private sector charges what it thinks the market will bear, and a key driver for pricing in the private sector is country capacity. Both sectors have strict limits on the amount of aggregate risk per country they will accept, but in the private sector, when capacity in a given country begins to become scarce, the cost of the premium rises regardless of the actual risk presented by that country, so that coverage becomes almost an auction.

Of course, where you have essential differences, you get competitive tensions. By the end of the 1970s, political risk insurance had become an established class of business. Lloyd’s of London had taken the lead, but corporate insurers were beginning to enter the market—AIG, for example, opened its political risk insurance book in 1979. In all marketplaces, the element of competition is a constant
influence on the conduct of business, and insurers seek to guard and build market share. Private sector insurers had built a book out of writing business the public sector could not or would not address, and, perhaps justifiably, it felt proprietorial about it. In those days, most insurers in the business had little knowledge of the public sector, and they viewed it, at best, with indifference. Those that gave it any real thought felt they were entitled to ownership of the business that had traditionally been the preserve of the public sector and felt that the public sector should be the insurer of last resort, taking only those risks the private sector could not or would not underwrite. What riled many insurers at that time, in what was still a tiny marketplace, was the knowledge that when claims arose on their business, they were well below the members of the Paris Club in the pecking order for recoveries.

It was into this environment that, in 1988, MIGA was created. The preamble to the MIGA Convention reads as follows: “The Multilateral Investment Guarantee Agency can play an important role in the encouragement of foreign investment, complementing national and regional investment guarantee programs and private insurers of noncommercial risk.”

This statement gave private sector insurers a clear signal that MIGA was not seeking to compete with them but to complement them. If there were any doubts about this, MIGA’s policy toward the private sector was amplified and enshrined in the body of the MIGA Convention. It was noted that the private sector’s chief motivation is profit and quality market share. Yet MIGA’s arrival was greeted mutely in London and in some quarters with dismay at the appearance of yet another tax-funded competitor. None of the insurers grasped then what many firmly believe now, which is that the message enshrined in the MIGA Convention offered an opportunity to enhance their portfolios.

Looking back, what is most surprising for cooperation is that the broker community in London also failed to spot the potential. After all, insurance brokers are by nature opportunistic and could have made a greater effort to use MIGA as a market and to see how MIGA could complement their usual market. In fact, there was and remains an obligation on the broker community to explore all potential markets for a risk, not just the ones they are most familiar with. This is a duty that is all too frequently overlooked.

Why was MIGA initially received in this way? MIGA’s appearance coincided with one of the private sector’s early crises. Significant losses in the private sector’s trade risk insurance book had led to a
withdrawal of reinsurance support, and a great many insurers had left the business. Those private sector insurers that remained were well placed, of course, as demand for the product remained strong, and they absorbed the business their competitors were no longer writing. Their business was doing well, and in some areas they were competing effectively with the official agencies. There was little incentive to develop a relationship with the public sector.

Furthermore, the private sector at the time was still not geared to working with MIGA. Tenors available were still restricted to three years, and there were still restrictions on providing cover to lenders.

Finally, there was still, in some key quarters, brooding suspicion about the public sector. MIGA was part of it, and it is likely that few people in the private sector, brokers and insurers alike, bothered to read the MIGA Convention.

In short, in the late 1980s the established private political risk insurance market was maturing but remained an adolescent. It was self-interested and headstrong. It was to be another decade before practical and cultural changes enabled the private insurance market for investment insurance to develop so as initially to compete and later to cooperate with the public sector.

The Revolution in the Marketplace in the Late 1990s

In 1990 the regulations governing the conduct of political risk insurance at Lloyd’s were relaxed to permit the provision of insurance to banks providing project finance to foreign investments.

In 1995 the first long-term political risks policy was placed at Lloyd’s. The policy was written in respect of an independent power project in a developing country, with a tenor of seven years. The project was ineligible for coverage from its sponsors’ own government agency; for the first time, a private sector insurer stepped in to fill the gap. There was no publicity and no fanfare surrounding this development, because, as is normal in the private sector, there were strict confidentiality provisions attached to the program, and in any case, both broker and insurer had their own reasons for keeping quiet about it. And yet the mould had been broken.

In 1996 AIG announced that it would offer long tenors for investment insurance. Initially, it offered 7-year tenors, but later it went to 10 years and in some instances to 15. The market widely regarded the lengthening of its tenors as motivated by AIG’s desire to
compete on equal terms for project and investment insurance with the public sector agencies.

Thus in 1997 Sovereign Insurance of Bermuda, backed by Ace and XL, was established, offering tenors comparable to AIG’s. The following year Zurich US Political Risk commenced underwriting on similar terms. It was not long before insurers at Lloyd’s altered their line structures to keep up with these new corporate players.

In the space of three years the commercial political risk marketplace for investment insurance had altered radically. For a start, the marketplace was no longer centered in London, as it had been for the previous 20 years. There was more capacity, and tenors were closer to those offered by the official agencies. By the end of the 1990s, therefore, there was a robust private sector that was able to compete with the public sector for investment insurance. All of the private sector’s advantages in terms of eligibility, speed of service, flexibility, and pricing were aggressively mobilized to sell this new product line. As a result, an increasing number of projects that would previously have found cover only in the public sector were insured privately.

It was roughly at this time that I was asked by a European investment insurance agency to visit and brief it on what was happening in the private sector for investment insurance. During the course of that conversation, it emerged that this agency was thinking hard about its future, as a consultant had persuasively argued that the private insurance sector was now so strong, so versatile, and apparently so firmly established for the long term that in the foreseeable future there would be no call for this agency’s products and they should seriously consider shutting up shop.

There are strongly held views, in a variety of sectors of society, that taxpayers’ money should not be used to support the provision of political risk insurance by export credit agencies or multilateral entities. This is a topic that might merit closer examination on another occasion, but it found strong expression in some—though certainly not all—sections of the political risk insurance market at the time. If the private sector was now able to accept the investment risks that had previously been insurable only in the public sector—and indeed, was making inroads into the public sector’s book—some argued, was the continued existence of agencies such as OPIC, MIGA, and all the other official agencies necessary or even desirable?

In my view, the flaw in both these standpoints lies in the cyclical nature of the global insurance industry, on which Clive Tobin has
already commented. Niche areas of insurance are particularly vulnerable to insurance cycles, as they require helpful reinsurance support, and of all niche classes of business, political risk insurance is probably the most susceptible. It is reasonable to predict that there will always be a private market, of some sort, for political risk insurance. But anyone who has watched its various mutations over the past 25 years would be reluctant to predict what shapes it will take in the next 25 years. The private sector went through two or three near fatal crises during the 1980s, faced with losses that arose largely from its trade risk book as opposed to its investment risk book. It surprised all of us how well the private sector weathered the events of 9/11, but as Clive Tobin pointed out, the subsequent decline in private sector capacity was matched by a decline in foreign direct investment looking for insurance, so equilibrium between supply and demand was maintained. In the past the public sector has been viewed as the insurer of last resort, and there may be a time in the future when it may be such again. In recent years—and, from my perspective, going forward—a key role of the public sector lies in the leadership and mobilization of insurance capacity for complex risks.

The Developing Partnerships: Progress and Pitfalls

When a private sector insurer works with a public sector insurer, the private sector insurer gains immediate access to a number of things that would not otherwise be available to it, namely:

- Access to business the private sector insurer would not otherwise see.
- Mitigation of risk, through the influence public sector agencies are able to employ, through their official channels, to reduce the likelihood of a loss or increase the likelihood of a recovery.
- Information. Public sector insurers have access to information that is not easily available to the private sector, which they frequently share with their private sector partners.

Initially, the private sector had only one thing to offer to a public sector insurer: capacity. However, in this business, capacity is king. We saw earlier that public and private insurers limit their aggregate country exposures and the effect it has in the private sector on risk pricing.
It was demand for political risk capacity that was the catalyst for closer cooperation between the private and public sectors in the late 1990s. The sheer scale of some of the overseas projects being financed at that time put severe strains on the public sector’s ability to meet the investors’ and financiers’ demands for insurance. Furthermore, the tenors involved meant that capacity allocated to projects would be tied up for many years, and an insurer, whether public or private, that allocated all of its capacity to a few projects in one year would have little capacity to participate in projects in subsequent years. In order to be able to preserve sufficient capacity for writing new risks, coverage would have to be allocated sparingly; the only way to meet present and anticipated future demand was to syndicate with the rest of the political risk insurance market, either by reinsurance or on a cooperative basis.

What the public sector found, in those early relationships, was that the private sector had other things to offer: a wealth of underwriting experience and recovery techniques; new ideas for the insurance portfolio administration and servicing; and innovations in coverage and insurance contract drafting. In one instance that my firm was involved with, facultative reinsurance was sought for a public agency on an investment risk. We not only enabled this but also suggested enhancements to that agency’s standard contract wording that brought it into line with (and thus enabled it to compete with) the latest developments in the private sector.

I noted earlier that essential differences in business culture lead naturally to competitive tensions, although it would be stretching the point to suggest that such tensions have led to a “turf war” between the private sector and the public sector. However, I am aware of at least two occasions—and there may be others—on which political risk insurance programs handled by a public sector insurer have been terminated and rewritten in the private sector. One of these incidents occurred shortly before coverage was to have been issued, but considerable resources had been spent in underwriting it. On both occasions, the incentive seems to have been a lower premium, which seems fair enough, but the irony is that one of these cases subsequently turned into a substantial loss. This kind of thing will not of itself cause issues between the private and public sectors. On both occasions, brokers were involved, and they did an excellent job for their clients. No doubt there have been other, similar cases of insurance programs being “poached” away from the public sector into the private sector. Since many public sector insurers provide details of their clients and the projects they have insured, it takes
only an enterprising broker to cold call those clients and offer a private sector alternative.

Some export credit agencies are more aggressive than others about marketing their services. One veteran political risk underwriter recently complained to me about the assault on his traditional customer base by a particularly energetic export credit agency.

The real potential for tension, I believe, arises not so much when the public and private sectors are competing with each other but when they are cooperating. The principle of cooperation is frequently evangelized at symposia and conferences such as this one, as it has been a staple topic for discussion for the past seven years. But I often wonder if there are any aspects to the public-private sector relationship that are disadvantages for one or both sides. There are certainly some things the private sector underwriter has to bear in mind:

- **Claims handling:** Insurers’ liability on a syndicated program is several and not joint. Is the policyholder to negotiate a claim with each insurer, both public and private, to settle a claim? Or is there to be a lead insurer with authority to lead claims negotiations? What happens if some insurers decide to dispute a claim? Is the agreement of the others to settle prejudicial to their argument?

- **Subrogation:** It is a requirement of many public sector agencies that in the event of a loss, the public sector insurer is entitled to 100 percent of the project that has been the subject of the loss, regardless of the amount of the loss or whether private sector insurers are also involved on the risk and in the claim.

- **Recoveries:** Private sector insurers will want to square their books by effecting a recovery of the loss they have paid as quickly as possible. Despite the absence of any real evidence, there remains the perception in some quarters that the national interest may occasionally affect the rigor with which a public sector agency pursues a recovery.

- **Apportionment of recoveries:** If recoveries are effected, who benefits first? The public sector insurer is the senior subrogee and must be made whole for its loss before the private sector insurer. How are the costs associated with effecting the recovery to be shared?

- **Consultation, information sharing, and decision making:** Is there a duty to share information among all insurers of a risk? Should any insurer be permitted to act unilaterally, even if the action is detrimental to the interests of the other insurers?
These pitfalls show that, when the private and public sectors work together on a risk, there is a clear need for a coinsurance agreement or claims cooperation agreement to be concluded in advance of the coverage being issued. But here again the friction between the two sectors surfaces. A public sector insurer is unlikely to be inclined to give up its sovereign privileges and freedom to maneuver simply in order to pacify its private sector partners. In the private sector, with its long history of syndicating risks in all classes of insurance business, insurers are more accustomed to yielding their rights to decide on certain aspects of policy administration, claims handling, and so forth to an agreed consensus, and indeed market practice has evolved over many years to establish this. But when the two sectors, whose status, rights, and methodology are so far apart, cooperate on the same project, a binding agreement among them as to how to deal with all of these issues on equal terms will be all but impossible to achieve.

Most coinsurance agreements between private and public sector insurers do not go much beyond a statement acknowledging the interest of each in the project and promising to make “best efforts” to preserve each other’s rights, share information, and consult on the appropriate action to take in the event of a loss. It may be possible to secure concrete agreement on the apportionment of recoveries and the allocation of costs, but it is often difficult to secure agreement that goes beyond a statement of mutual support. And yet insurers’ expectations when assuming a risk is that there will not be a loss and that the benefits to the private sector of working with the public sector generally, though not always, outweigh the drawbacks.

Some years ago insurers in the London market coinsured a project enterprise with a public sector insurance agency. For excellent reasons the public sector insurer terminated its coverage. The private insurer, which had written the risk partially on the basis of the comfort provided by the presence of a public insurer, had not been consulted or forewarned by its public sector counterpart, or at least not to the extent that it felt was due to a partner on the coverage, and remained “on risk.” Instantly, it felt doubly exposed: not only had the public sector insurer withdrawn from the program, the withdrawal was in circumstances that might even have prompted the host government to move against the project. The public sector insurer had acted within its rights, and in the end there was no loss. But this incident only fueled suspicions about the public sector that some parts of the private sector occasionally harbor.
More recently, a substantial claim arose on a program in which a public sector agency and private insurers had collaborated. The claim was paid, after which the public sector set about negotiating the recovery; it was successful in securing a settlement for itself and its private sector partners. Naturally, the agency’s private partners were delighted, though some sensed that the task of looking after their interests as well as its own was burdensome to the public sector insurer and that it found its freedom of movement hampered. Nevertheless, the fact remains that this was a successful partnership and a good indicator of growing awareness of the importance of looking after partner’s interests.

Perhaps the best-known example of a coinsurance agreement between the private and public sectors is the Cooperative Underwriting Program (CUP) introduced by MIGA in 1996. Under this unique contractual arrangement, participating private sector insurers assume the privileges enjoyed by MIGA in the eyes of the host government, retaining their several liability and the authority to make their own decisions in the matter of claims and recovery actions (although given that MIGA binds itself to work on their behalf as well as its own and to share recoveries pari passu, private sector partners under the CUP program would need to think very hard before striking out on their own). The disadvantages for the private sector in partnering with public sector agencies that we looked at earlier arise chiefly from the fact that private sector insurers are subordinate in status to their public sector counterparts. MIGA’s CUP solves that problem by simply enhancing the private sector partners’ status, for practical purposes, to the same as its own.

What is open to MIGA, as a multilateral agency, to arrange in its relations with the private sector is not so readily available to other public sector agencies. If it is not yet possible for other public sector insurers to enter into truly binding coinsurance agreements with private underwriters, it will remain critically important that both sides clearly understand each other’s motivations, limitations, and interests and seek practical ways of observing them.

**Reinsurance**

So far I have focused on the issues that arise when risks are syndicated severally among public and private insurers. But this is not the only manifestation of the relationship between the two sectors. Before concluding, I need to address reinsurance.
The reinsurance of the public sector by the private sector is long established. During the 1970s OPIC reinsured in the London market, and indeed, some export credit agencies have had reinsurance treaties underwritten in the private sector for many years.

*Treaty reinsurance* is the term given to an arrangement under which one insurer cedes a portion of a portfolio of risks (rather than single risks) to another insurer (the “reinsurer”). Traditionally, in political risk insurance most reinsurance treaties have been underwritten in respect of short-term export credit insurance, reflecting what used to be the private sector’s limitations as to risk tenors. Appetite for treaty reinsurance in the private sector is stimulated by the knowledge that, in accepting a share of a public agency’s entire portfolio, it will be accessing a good spread of business from the ceding company.

For the ceding company, there are two advantages. The first, of course, is that enhanced underwriting capability enables them to meet the changing demands of their customers as they tap new markets or build up otherwise unsustainable aggregate exposures in their existing markets. There is a second advantage, which is not always immediately apparent. In recent years a great many new export credit agencies were created, as new sovereign nations came into being after the end of the Cold War. What a great many of these needed was not only the financial resources to underpin their fledgling operations but also raw technical expertise in the underwriting of export credit insurance. The private sector, in the form of specialist reinsurance companies and brokers, is playing an important role here, in providing technical advice and training services in addition to reinsurance. In one instance, involving the new export credit agency of a nation that was emerging from years of conflict, 100 percent of its portfolio was ceded under its reinsurance treaty, so that the export credit agency retained no risk at all. The reinsurers also provided technical, underwriting, and developmental assistance, retaining, initially at least, control over the underwriting decisions the export credit agency made. As this export credit agency has matured, it has each year retained a little more of its risk and ceded less, and it now has underwriting autonomy. Without the nurturing support of its private sector reinsurers, its development would have been painfully slow.

The advent of longer tenors in the investment insurance marketplace has made it possible for public sector investment insurers to seek reinsurance in the private sector. MIGA’s announcement in 1997 that it had concluded a reinsurance treaty with Ace (and
subsequently XL) was a landmark in this respect, because for the first time, private sector insurers were signalling that they could and would reinsure risks tenors of 15 and even 20 years.

The most interesting recent development is the reinsurance by the public sector of private sector insurers. Some would say this is nothing new: after all, some export credit agencies, notably the Export Credits Guarantee Department of Great Britain, remained ultimate reinsurers of their short-term export credit portfolios following privatization for risks the new owners were unable to accept. That type of coverage, however, was usually in the national interest. What is happening now is different: OPIC and Montpelier Re recently announced the creation of a facility under which Montpelier Re, reinsured by OPIC, would provide terrorism insurance for assets owned overseas by U.S. corporations. This was not the first such instance: in 2003 Sovereign announced that it had obtained reinsurance support from the Export Development Corporation of Canada (EDC) in respect of a Brazilian project.

Facultative reinsurance (the reinsurance of single transactions rather than portfolios of risk) has become equally well established. But here, as in other areas of the public-private sector relationship that we noted earlier, lurk misgivings that need to be overcome. For example, private sector underwriters often suspect “anti-selection” against them by public sector insurers, perceiving that public sector insurers retain the better risks in full and cede the ones they are less happy with to the private sector. Another misgiving that is often vented by facultative reinsurers is that since they are bound to follow the decisions of a reinsured entity that is motivated by factors other than purely commercial considerations—for example, the national interest—they can never be certain how tough a line the public entity will take in pursuing recoveries. I have seen no evidence to support either concern, but they are clear indicators that potential for tensions in the relationship between the two sectors is never far away.

Where Next?

If I have focused too much on the potential for misunderstandings and pitfalls, it is partly because, as a broker, it is part of my job to try and anticipate difficulties before they arise and work to neutralize them. It was time to take a closer look at these issues, not least because in the often euphoric presentation of the “brave new world” of public-private sector partnerships, too little emphasis is placed on the potential for conflict.
The plain fact is, though, that the past 10 years have seen an extraordinary growth in cooperative activity between the private and public sectors, both in syndications and reinsurance. MIGA alone has syndicated several dozen contracts with 20-odd private sector insurers. I have alluded to the work being done in this area by Zurich and Sovereign with other agencies and, of course, AIG and OPIC. Multilateral lending agencies are also beginning to work with the private sector in risk syndications.

The fundamental reason for this, in my view, is that the private market has matured. From experience cooperating with the public sector, it has learned that the commercial opportunities in doing so far outweigh any objections presented by the practical difficulties presented by their differences in status. The sectors understand each other far more, and they take greater care to look after each other’s interests when partnering. A lot of this reflects experience, but it is also attributable to several factors.

The first is a comparatively recent development, represented by the transfer of techniques, experience, and expertise when senior individual practitioners migrate from one sector to the other. A number of senior figures in the private sector, both insurers and brokers, were originally senior figures in the public sector, and vice versa. Three key private sector insurers, AIG, Sovereign, and Zurich, are now members of the Berne Union. This crossover of expertise and experience can only enhance the collaborative process and blunt the effects of the inherent differences between the two sectors.

Second, since 9/11 the level of cross-border activity looking for political risk insurance has fallen. Meanwhile, private sector capacity has increased back to pretty much where it was before 9/11, and capacity needs feeding. I attribute, in some measure at least, the private sector’s increased collaboration with the public sector to the need to develop new sources of premium income as traditional sources have stagnated.

This is the first of several points to ponder as we consider the future of the industry. It begs the question as to what would happen if the political risks market were to return to the harder market of the late 1990s, when demand for coverage was greater and rates were higher.

Coupled with this is the point Clive Tobin makes about the product range in his paper, that consumers of coverage are increasingly demanding obligor-default risk coverage, and, I would add, in some quarters, effective protection against currency fluctuation and devaluation exposures. It is quite true that if the coverages offered by our
markets are to be broadened, they must be priced accordingly, but it is also true that a great deal of discipline will be needed if the private sector is to avoid writing itself into a series of catastrophic losses.

The third factor to bear in mind when looking to the future is the health of the global reinsurance marketplace. The private sector relies greatly on the availability of reinsurance capacity, along with reinsurers’ willingness to provide the tenors and conditions that enable it to match those available in the public sector and thus collaborate with it. But a catastrophic series of events might once again traumatize the reinsurance industry, without softening demand for political risk insurance, as 9/11 did.

With the technical and cultural foundations laid, cooperation between the two sectors has been firmly established and has become a customary part of the private sector’s book. I believe cooperation is here to stay. But I would like to offer a few scenarios for the possible development of the relationship between the public and private sectors over the next few years.

The first assumes that current trends and market conditions are maintained and that cross-border projects and trading increase, thus increasing demand for our products until current overcapacity is filled. With the collaborative foundations between the two sectors firmly laid, we can expect a great many more instances of cooperation. Along the way, of course, we may see some private sector insurers seeking to compete with and undercut the public sector, but I believe it will be generally understood, among a more discerning and sophisticated customer base, that good-quality coverage is best mobilized by exploiting the new partnerships between public and private sector carriers.

Another thing I see happening in this process is more diligent marketing of such risks by the broker community to the public sector, which to date has, to my mind, been patchy. One would hope that recent events in the broking sector will encourage practitioners to market business to all potential insurers, including the public sector.

The second is a more “doomsday” approach, which assumes the intervention of adverse events both within and outside the political risk insurance industry. With the benefit of hindsight, one could claim to see the “meltdowns” of the last decade coming in Russia, Southeast Asia, Argentina, Venezuela, and elsewhere. But the fact is, a great many insurers were caught “on the hop” and paid substantial claims. We have to expect similar crises in the future and that the resulting claims might wipe out several years’ premium earnings at a stroke. We also have to expect catastrophes affecting the global
insurance industry: an earthquake in a densely populated, high-value area, such as Tokyo or California, coupled with the usual hurricanes, floods in Europe, and so on. Were all such events to occur in the space of a short time, coupled with political risk losses, to form a hard reinsurance market, the resulting contraction in private sector capacity and tenors would greatly affect the sector’s ability to work with the public sector as it now does. In addition, some private sector insurers could see a drop in their ratings, which might make them unacceptable to customers and public sector partners alike.

Finally, a third scenario could arise from the development of new techniques for managing exposure or enhancing capacity, such as credit default swaps and securitization. Techniques in this category have been developed by export credit insurers and indeed put to use by some export credit agencies. As far as I know (and perhaps someone may prove me wrong), this technology has not yet been adapted to political risk, but there are those of us in the private sector who are looking closely at the possibilities. That would form the subject, perhaps, of a paper at the next MIGA-Georgetown Symposium, at which point, I hope, we shall be able to see exactly how much farther the private-public sector partnership has developed.
Discussion of the Evolution of Private-Public Relationships in Political Risk Insurance

Symposium Panelists and Participants

The discussion and commentary following the Tobin and Heppel presentations was wide-ranging, encompassing derivatives, credit insurance, and financial guarantees; sources of cooperation and tension between public and private insurers; and MIGA’s CUP and other public-private relationships, including reinsurance.

Derivatives, Credit Insurance, and Financial Guarantees

Question: For a company like XL Insurance, which already has a lot of aggregation of political risk, would not offering a derivative associated with political risk exponentially increase the firm’s aggregates even further?

Tobin: With regard to aggregation of risk, any contract written in insurance form potentially allows the issuer access to the reinsurance industry. A derivative, in contrast, may not have access to the reinsurance industry. But to the extent that there is limited appetite for political risks in the reinsurance industry right now, the issuer may have to self-insure, and XL is quite comfortable doing this via a derivative. One simply has to monitor the exposures, especially the market-to-market risks.

Question: There is heavy demand for credit insurance. But given the great losses in this segment of the market, is there likely to be an increase in capacity for credit insurance?

Tobin: In terms of credit enhancement, there are many transactions in which the real question is whether XL wants to take the whole risk, for example, as a financial guarantee company. In Chile, XL
wrapped the bonds for a toll road. In Mexico, XL was a big supporter of the Pemex future flow transactions. In these transactions XL did not try to separate out the political risk cover. Alternatively, a borrower could buy political risk cover to raise its bonds to investment grade, and then those investment-grade bonds could theoretically be elevated to AAA by a financial guarantee company. Some insurers prefer to take the whole risk rather than have the risks sliced up, because with separate premiums for different exposures, the true benefit may be lost.

There should be more of a focus on credit enhancement opportunities coming out of Latin America. It is also interesting to see what evolves in China; there certainly could be a lot of appetite now for future transactions from China. For any country whose borrowers are trying to place themselves above the sovereign ceiling, one route could be a two-step process of getting political risk cover to achieve an investment grade and then obtaining the investment enhancement. A second route is to structure the transaction outside the non-investment grade country, thus making sure that convertibility and the currency exposure are removed by keeping payments offshore, laying the basis for a full financial guarantee.

Question: XL writes political risk insurance which is contingent and financial guarantee insurance that is irrevocable and without waivers. There have been proposals at this symposium to make political risk insurance contracts more complex to encompass every kind of contingency, whereas with a financial guarantee insurance policy, if there is a dollar payment not paid when due, the payment from the guarantor becomes due without asking questions. From the point of view of a company that serves both markets, how does XL assess a financial guarantee that pays automatically versus political risk coverage, where one can send in lawyers to decide whether or not there is a valid claim?

Tobin: For future flow transactions, where there is a trading relationship built around a physical asset, XL feels much more comfortable with a financial guarantee mechanism with payment through future flow transactions. So XL feels very comfortable using guarantees to support those types of transactions.

If the transactions are less certain, if they are not future flow transactions but, for example, transactions in which XL would be guaranteeing some of the transactions coming out of Argentine tax receipts and things of that nature, with local operations involved
and nothing being exported, XL would feel much more comfortable working on a political risk insurance basis, because the variability of exposure is so much greater.

**Question:** In discussing insurance versus financial guarantees, one thing that has not been mentioned is that in writing insurance the insurer relies on the insured to document the transaction and do all the things necessary to have a payment obligation in its favor or a proper investment, whereas in the financial guarantee business, the guarantor is, in effect, taking on the role of a lender, except that the guarantor is not putting up money. Does the insurance underwriter community have the ability to document loan transactions and go through a process like the very large Pemex deal, which has been well structured and well lawyered?

**Tobin:** This is a very important issue. On a highly structured deal, XL would not simply review the documentation internally but would typically have Standard and Poor’s (S&P) or somebody else review the whole transaction and assess the capital charge associated with it. Clearly, a company like XL cannot afford to do a transaction and then find three months later that S&P’s view of the capital allocated to that transaction is a multiple of what XL thought it had allocated. So it is very important when XL does highly structured transactions that the company assess the capital charge, work with a rating agency, and then decide how to price it based on that analysis.

But there are other transactions, in the political risk arena, that would not be as complex as that, where the client would suffer if XL levied specific capital charges against specific transactions rather than evaluating exposure on a portfolio basis while trying to get some analyses from a ratings agency. So, in general, for a highly structured future flow or a highly structured transaction within a country, XL would typically do it in a financial guarantee form. But for a simpler credit enhancement, XL would likely look to do it in a political risk insurance format.

**Sources of Cooperation and Tension in Public-Private Relationships**

**Question:** To what extent does the private market want to have a public market layer in a syndication, and, if it does, what is the rationale?

**Heppel:** The perceived upside of syndicating and working with the
public sector insurer or multilateral is the influence that they can bring to bear to minimize or avoid a claim or, indeed, to effect recoveries more efficiently than the private sector could on its own. That is the upside. The downside, of course, is that if the arrangements between public and private participants are not properly structured and do not recognize each other’s positions adequately, the private sector tends to be subordinate in rights to the public sector. The prevailing wisdom among the majority of insurers, with one or two dissenting, is that they would prefer to work with the public sector insurer if they see that it brings real value to them, and they will take a more benign view of the risk.

**Tobin:** XL would generally agree with that perception. In addition, in certain geographic regions, it has become standard for transactions to get done with public-private cooperation. This is an evolving practice, but certainly, in many key areas of the world, XL would not want to operate without partnership involving the public sector. In projects where clients are looking for very long tenors, the need to work in partnerships with public entities is very strong. XL values the risk mitigation associated with collaboration on such projects and takes great comfort in having agency support.

**Question:** The public sector is sometimes chastised for “crowding out” the private sector. This kind of criticism seems to suggest that there is a scarce amount of risk out there, and the public and private sectors are fighting over it. Isn’t it the case that there is more than enough risk to go around, for all parties to take as much as they want?

**Heppel:** It is not accurate to say that the public sector is crowding the private sector out, although there is a sort of competitive tension and suspicion that the private sector, having moved onto the public sector’s turf, now “owns” it and wants to fight off the public sector trying to get back into it.

The eligibility issue is one that should at least temper the private sector’s concerns about the public sector. Private insurers can go out and cover whatever people want to insure, because they have no issues with new investments versus existing ones or who owns the investment or, indeed, what the investment is about.

The public sector can take up a lot of the risks that the private sector cannot or will not accept or at least mobilize capacity to enable private sector insurers to go where they would not normally
go unaccompanied. This creates an interesting philosophical issue for the industry. On the one hand, there is this competitive tension that the private sector can do it all and that the public sector need not play a role. On the other hand, there is the suggestion that, yes, the public sector is a valuable partner and that the two sectors should make the best use of each other’s strengths. The attitude varies enormously among participants in the insurance market at any given time, and attitudes have swung backward and forward quite a lot over the past 10 years.

MIGA’s CUP and Other Public-Private Relationships, Including Reinsurance

Question: The proposition has been advanced that CUP arrangements, in which MIGA fronts for other insurers, is a very tidy way of dealing with the issues of coinsurance and claims cooperation. But CUP arrangements are costly, and that cost has to be absorbed by somebody, so not everyone in the industry finds that the most convenient way to work. When the CUP arrangement is used, what sort of progress is being made in resolving some of the issues associated with claims cooperation and particularly coinsurance?

MIGA representative: When MIGA syndicates transactions under the CUP or facultative insurance, it charges a fee for collecting and syndicating the coverage into the market. That is not dissimilar from syndicating any other product. However, when MIGA is syndicating into the private market, it sets the price as it perceives the risk, which quite often is significantly different from what the private market would charge for that same risk if it were going into that same deal on its own. Normally—probably 95 percent of the time—the private market will follow MIGA’s pricing. The result is that there may be a fee at the front for the actual work in syndication, but the overall saving over the life of the transaction would make that amount pale in comparison with the overall cost of the transaction. So from the clients’ point of view, they have a transaction with MIGA and a single policy with MIGA. They do not have to worry about multiple policies and claims cooperation agreements.

Heppel: Still, it is sometimes difficult for private and public sector insurers to work together because of their differing status. Cooperation clauses appear to be very little more than statements to take care and look out for each other and recognize each other’s interests
as existing. There have been some agreements on the apportionment of recoveries and also the cost of those recoveries. But there is a considerable amount of work to be done in this area.

Tobin: Nonetheless, it is important to point out that by fronting these policies, MIGA takes the credit risk, and carrying that credit risk is not an insignificant contribution.

Question: Given that XL is an AAA guarantor and a direct political risk insurer, what are the prospects for more effective public-private collaborations?

Response: When XL moved into capital markets transactions, there were structures that could be used from its property/casualty companies to insure mezzanine layers or primary risk, that we did not see in the capital markets. XL began to work with parties where XL would fund a certain layer considered to be noninvestment grade, create a structure that would reach investment grade, and wrap or work with other agencies to help us do that.

Question: Cooperation between the private sector and the public sector has taken many forms over the last 5–10 years. It has taken the form of the CUP; it has taken the form of coinsurance and reinsurance. Most recently, there has been more evidence of export credit agencies and other public agencies willing to reinsure the private market. Is this public sector reinsuring of the private market likely to be a longer-term trend?

Tobin: This is a welcome development, because one of the challenges right now is that there is huge concentration in the reinsurance market. The concentration of risk to a decreasing number of insurers is causing a great deal of capital stress. The ability to have reinsurance partnerships that include the public sector would be very attractive to XL.

Comment: One of the key reasons driving a lot of reinsurance approaches to the market by export credit agencies has been portfolio risk management, which has been absent in the past and has very much come forward now, in the sense that export credit agencies cannot control what is in their book. As a result, it is difficult to create balance, thereby reducing reserves. Standing behind the commercial market can provide a more balanced portfolio and lower overall reserves. This is a useful instrument for both sides and not just a marketing ploy.
Heppel: The growing reinsurance of export credit agencies arises for all sorts of different reasons, but the fundamental reason is that they do not have that much choice about how they shape their book. Their exposure arises from the demands of their customer base that they do have to service, and this exposure needs to be balanced.

Question: The argument has been made that with the weakening or softening of property, casualty, and other segments of the insurance industry, there is likely to be some substantial increase in insurance capacity in the political risk arena. What is the basis for this argument?

Tobin: Reinsurance capacity will not necessarily come from the traditional reinsurance market. Rather, the source of reinsurance will be the new Bermuda capital that came in after September 11. Many of those companies had 75–100 percent of their business in property coverage. What has happened now is that property rates are coming under pressure; as rates start to fall, these companies will have to diversify their lines. They will then look at noncorrelating lines of insurance. Political risk is an area in which some have little or no expertise. They will talk to political risk insurance writers about how they can support them or coinsure with them. That will represent an opportunity.

There is also potential that companies will be able to work with some of the syndicates in Lloyd’s to get more capacity from there as well. So political risk capacity is likely to come from a much greater variety of sources than it did in the past.

Considering the cycles in the insurance market, the insurance industry seems never to have missed an opportunity to miss an opportunity to avoid a cyclical market. In the next two years, if the market does drop, insurance companies will have to buy earnings again, and they will do it through mergers and acquisitions. It will be interesting looking at where that activity will come from. If there is significant consolidation in the insurance industry, there may be a willingness to keep bigger retention, because of the size and diversity of the balance sheet, and that will help the political risk sector.

Question: Highly structured transactions with first loss, second loss, and so on are more complicated than traditional straight reinsurance. In financial markets there are sophisticated ways to price this first loss, second loss according to the different distributions of risk. Are there systems in place in the political risk industry that can reflect this risk structure and price accordingly? It has been argued
that those systems do not exist. Therefore, the appropriate price differentiation is not present, and that is part of the reason why one does not see more of these highly structured deals. Are the systems out there that would allow this to develop?

*Tobin:* In these types of transactions, we would try to use two benchmarks for pricing. The first benchmark is pricing the probability of exposure, the potential for default. The second benchmark is an open market pricing mechanism. So if we were looking at a mezzanine layer, we would structure it based on an assessment of the probability of default. But it would also be benchmarked against, for example, what equity people would be looking for in terms of funding the mezzanine layer in the transaction.

For the higher layers, we would tend to work much more closely with companies like S&P to make sure there is a similarity of views on the probability ratios. But if the investment transaction would be rated by S&P as noninvestment grade, clearly we would not be able to pursue that benchmark. One of the strengths XL brings with its political risk and financial guarantee operations is if the layer is non-investment grade, XL can write coverage through a multiline company and it becomes an AA transaction. Even though S&P may rate it as a BB transaction, XL can decide how to structure its involvement and how to enhance it. But certainly if a transaction is not rated with a shadow rating of BBB or better by S&P, XL will be unable to wrap it to AAA through XL’s financial guarantee company. XL will work across different companies to make sure that it can bring the right credit enhancement to the transaction based on S&P shadow rating.
An area in which a specialized form of currency transfer and inconvertibility coverage has been used with growing success is the provision of support for bond issuers in select emerging markets. This topic is addressed by Christina Westholm-Schröder, Chief Underwriter of Sovereign Risk Insurance Ltd. of Bermuda.

Traditional coverage for currency transfer and convertibility has always generated some frustration, disappointment, and controversy. Daniel Riordan, Executive Vice President and Managing Director of Zurich Emerging Markets Solutions, and Edward Coppola, Zurich’s Senior Vice President and Chief Underwriting Officer, ask whether it is an old reliable product or just an old product.

In “The Use of Political Risk Insurance to Support Emerging Market-Based Issuers,” Christina Westholm-Schröder points out that a form of political risk insurance that covers the risks of currency transfer and convertibility (T&C) has allowed some highly rated emerging market issuers to “pierce the sovereign ceiling” to achieve a foreign currency rating that is the same as or similar to their local currency rating. International investors that required an investment-grade rating could thereby enjoy the superior yield from the bonds of emerging market companies located in sub-investment-grade countries. By the fall of
2004, some 30 issuers had used such policies to issue debt rated higher than the governments of the countries in which they were located, including Argentina, Belize, Brazil, Costa Rica, El Salvador, Mexico, the Philippines, and Turkey.

The importance of this type of coverage has grown with the evolution of international capital markets. Official development assistance has given way to a much larger volume of private capital flows, of which FDI and portfolio investments represent the largest fraction. Pension funds and other investors have wanted access to the higher returns available in emerging markets, as well as greater diversification of their portfolios. Traditionally, they have participated in developing markets through government loans and bonds. Increasingly, however, they have wanted to include bonds issued by companies in developing countries.

Institutional investors typically require investments to meet two minimum standards. First is the local currency rating, which evaluates the issuer’s capability and willingness to fulfill its obligations to repay debts in the local currency given business conditions where it is located. Second is a foreign currency rating, which evaluates the same issues but also takes into account the risk that host authorities may introduce restrictions on the ability to obtain foreign exchange and service the off-shore debt. In developing countries there can be a significant divergence between the two ratings, penalizing a solid A-rated company in a BB-rated country either by raising the premium the company pays to obtain foreign funding and by excluding the company from the portfolios of investors that require investment-grade ratings. (The foreign currency rating of a corporate entity is usually capped by the foreign currency rating of the host country, the “sovereign ceiling.”)

In recent years, some local companies have been able to benefit from different structures designed to allow them to pierce the sovereign ceiling. Higher foreign currency ratings have been obtained via transactions backed by export receivables; transactions with a multilateral agency B-loan structure; transactions with a rolling, reinstatable foreign currency guarantee from a multilateral agency; transactions with a strong foreign partner; and transactions backed by political risk insurance.
One type of political risk insurance, T&C coverage, makes foreign exchange available to fund debt payments during a period when the country imposes convertibility restrictions, nontransfer restrictions, or both. The foreign currency rating can thus be raised to the company’s domestic currency rating, which may be higher than the sovereign rating. (The political risk insurance policy cannot, however, enhance the company’s domestic currency rating or provide coverage against other forms of country or “political” risk.)

There are some differences between this new form of the policy and traditional T&C coverage. First, the new coverage recognizes that the insured party, normally the trustee, has limited ability to perform duties customarily required of an insured under a political risk insurance policy, so the policy is amended to take this restriction into account. Many of the obligations normally performed by the insured are assumed by the issuer through a separate agreement (signed by the insured and the issuer). Second, the time line for paying a claim is very specifically defined. One of the main criteria for the rating agencies—and, indeed, one of the premises for the effectiveness of T&C coverage and the reason why rating agencies are able to allow for a higher rating—is the added comfort that there be no missed or delayed installment payments.

How much enhancement this political risk insurance coverage imparts depends on the proprietary rating methodology of individual agencies, such as Moody’s, Standard and Poor’s, and Fitch. These proprietary rating systems include many complex components, including an estimation of the likelihood of a crisis interrupting debt service; the expected duration of the crisis (e.g., 18 months in Latin America, 24 months in Turkey); and the probability of one or more crises occurring during the tenor of the obligation (e.g., an issue of more than 10 years may require that the political risk insurance coverage be reinstatable). The analysis also takes into account the amount of the debt service coverage required and the claims payment record of the insurer.

Thus by enabling the issuer to pierce the sovereign ceiling, this form of T&C coverage allows the issuer to substantially lower its borrowing costs and to gain access to a larger pool of investment funds. Utilizing this coverage in 2003, Banco Bradesco of Brazil
issued $500 million of debt that was rated seven notches above the sovereign ceiling of Brazil, with the benefit of a policy covering 18 months worth of payments. In 2004 Finans Bank of Turkey achieved a rating two notches above that of the Turkish government for subordinated debt issue with a 10-year maturity.

Christina Westholm-Schröder concludes that this adaptation of the traditional T&C coverage has become an accepted structure for piercing the sovereign ceiling, and there is now substantial experience among investors and rating agencies with its usage.

In “Currency Transfer and Convertibility Coverage: An Old Reliable Product or Just an Old Product?” Daniel Riordan and Edward Coppola observe that currency inconvertibility (CI) coverage is designed to protect against the risk of not being able to convert local currency into a foreign currency and transfer those funds outside the country. Over the past 50 years, it has been the most tested political risk insurance coverage and probably the least changed. The coverage requires that the insured company, or a lender to the company, have used all legal means during the waiting period to convert and remit the funds. A change in the value of the currency—devaluation coverage—has been a standard exclusion in CI coverage, because it has been assumed to be a commercial risk (and considered by many to be uninsurable). In the event of a claim, the underwriter must have clear and unencumbered subrogation rights to the underlying payment obligation and to the blocked funds.

The authors ask: does CI risk still exist and is it worth insuring? They answer with a qualified yes to both questions.

As part of the enormous expansion in the size and tenor of coverages in the late 1990s, there was intense demand from banks for CI coverage. In some cases the credit committees of the banks—and their regulators—allowed cross-border exposures that had CI coverage excluded from their country lending limits, thus affording lenders considerable leverage. As Christina Westholm-Schröder has noted, CI coverage has also greatly benefited capital markets, since rating agencies have allowed bonds protected by CI policies to be rated higher than host country sovereign debt. Finally, CI coverage has been a boon to equity investors, ensuring their ability to repatriate profits and dividends from their projects.
Currently, there is considerable skepticism about CI coverage. The Argentine crisis provoked some insureds and brokers to conclude that CI coverage is no longer viable. The criticism is made that buyers did not understand what they were buying and that insurers were determined to avoid or minimize the payment of claims. With the loss of confidence in CI coverage, the demand from financial institutions has dropped sharply. At the same time, inquiries about nonhonoring coverage for cross-border sovereign payment risk and comprehensive credit insurance have increased. Before pronouncing CI coverage dead, it should be noted that requests from equity investors have not dropped.

Riordan and Coppola note that the current debate over the value of CI sidesteps an important feature of the service insurers provided by interceding when events occur that could have the potential for maturing into claims. In the Argentine case, public insurers and some private underwriters were able to use their membership in the Berne Union to secure exemptions from exchange controls for their clients, allowing clients to remit their funds abroad without filing an insurance claim. In Venezuela underwriters helped their clients navigate through the foreign exchange control regulations and bureaucracy, obtaining foreign exchange to remit outside of the country. In both cases the record shows that underwriters have not simply tried to walk away from their clients and avoid paying claims. Indeed, the premium insureds pay has gained them more than simply compensation in the event of a covered loss.

The Argentine crisis has triggered renewed interest in the management of devaluation risk. This has been stimulated, in part, by the senior management of some financial institutions that mistakenly thought that devaluation risk was already included in their firm’s purchase of CI coverage.

The most serious attempts to address devaluation risk have focused—as the paper by Kenneth Hansen pointed out in the 2002 MIGA-Georgetown Symposium—on providing a revolving fund to address the mismatch between local currency receipts for infrastructure services and foreign currency loan payments to project lenders. Only a few transactions have been completed using this model, first developed by OPIC. However, the OPIC coverage was structured as a guaranty rather
than insurance, and private political risk insurers generally cannot offer a guaranty.

One of the chief complaints about traditional CI coverage is that insureds, borrowers, or both must take all legal means to convert and remit funds before they can submit an insurance claim. This can be a complex and time-consuming process. Perhaps CI coverage could be modified to require that insureds and borrowers attempt only what had been the traditional mechanisms for conversion and remittance of funds and not necessarily be required to resort to more exotic and indirect means to convert and remit funds. This modification of CI coverage would likely require a higher price and might necessitate a longer waiting period.

Riordan and Coppola close by arguing that it is time to reinvigorate investor interest in CI coverage. In particular, enhanced CI coverage should be seen by financial institutions as a valuable and viable product.
The Use of Political Risk Insurance to Support Emerging Market-Based Issuers

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Since the end of the 1990s, banks and large corporations in a number of emerging markets have used a specialized form of political risk insurance to enhance the foreign currency ratings of their debt issued in the international capital markets. The particular coverage afforded by these policies protects the insured against the risks of currency inconvertibility and nontransfer, often referred to as transfer and convertibility (T&C). Such T&C policies are designed to allow highly rated emerging market issuers to “pierce the sovereign ceiling” and obtain a foreign currency rating that is the same as or similar to their local currency rating. This specialized form of political risk insurance was developed to enhance the rating of securities issued by companies domiciled in sub-investment-grade countries, in order to attract international investors that require an investment-grade rating but that are interested in earning the higher yields of emerging market assets.

The market’s interest in using political risk insurance to enhance emerging market bond issues was triggered in 1999, when OPIC amended its traditional inconvertibility policy to meet the needs of capital market participants. OPIC issued several policies, and private insurers quickly followed OPIC’s lead in developing this new product. Since then private insurers have been the most active participants in this market, and policies have been further refined to accommodate the changing requirements of rating agencies and investors. By the fall of 2004, some 30 issuers in Argentina, Belize, Brazil, Costa Rica,
El Salvador, Mexico, the Philippines, and Turkey had used political risk insurance policies to issue debt rated higher than that of their respective governments in the international capital markets.

Issuers have been particularly interested in political risk insurance support when issuing subordinated debt, structured and recognized by bank regulators as tier-two capital. One example of such an issue is the Banco Bradesco S.A. of Brazil’s $500 million issue in 2003, which was very well received by investors and which achieved a spectacular seven-notch ratings upgrade. Another interesting structure is the Tele Norte Leste Participações S.A. transaction, insured by Sovereign in the fall of 2003. In this case, a national export credit agency, the Export Development Corporation of Canada, for the first time reinsured a private underwriter on a capital markets policy in order to provide adequate capacity to insure the $300 million issue, at a time when Brazilian capacity was virtually nonexistent among private underwriters.

Overview and Background: The Evolution of Capital Flows to Emerging Markets

Whereas official assistance, in the form of bilateral and multilateral loans, previously made up the majority of capital flows into emerging markets, the capital flows from private sources are today a far more important source of funding to emerging markets. This change in the source of capital flows has been accompanied by a change in the composition, as well as the destination, of private capital flows. Up until the 1982–83 Latin American debt crisis, capital flowed mainly to public sector entities, usually in the form of commercial bank loans. With the decreasing role of the state in these economies and the emergence of a vibrant private sector, the largest portion of the capital flows today is instead directed to private companies and banks. This capital is increasingly provided in the form of equity, either as FDI, portfolio investments, or loans from nonbank institutions. Today the largest portion of capital flows is equity capital, accounting for approximately 40–50 percent of total capital flows. Commercial bank loans today provide a relatively small portion of the capital flows, whereas other forms of debt financing are increasing.

The changes in the composition of capital flows are partly explained by the growth of international capital markets in general. Pension fund investors, for example, have a large amount of money to invest and are seeking an alternative to the more traditional investment strategy in OECD countries. Investors’ interest in
emerging markets was initially limited to government loans and bonds, for which ratings have been available for several years. However, the growing sophistication of emerging market economies and the increasing number of rated companies have led to an expansion of international investors’ appetites to also include private emerging market assets.

What Do Ratings Tell You and Why Are They Important?

Ratings provide guidance to investors. They are particularly useful to investors entering new markets. International ratings also provide a comparable measuring tool among different jurisdictions. Most institutional investors apply a minimum rating level as a pre-condition to investing in a particular security.

There are two different ratings: a local currency rating and a foreign currency rating. For companies domiciled in OECD countries, these ratings tend to be the same. For entities in emerging markets, however, there can be a substantial divergence between the two, because the foreign currency rating of an entity is usually capped by the foreign currency rating of the government of its home country (the “sovereign ceiling”).

The local currency rating of an issuer addresses its ability and willingness to meet its obligations in local currency. Such a rating takes into consideration the overall macroeconomic environment in the country in which the issuer is domiciled, including variables such as interest rates, inflation, and the regulatory and judicial environment. It does not take into account the ability of an issuer to repay foreign currency obligations. The local currency rating reflects the credit and operational risks in the country of the issuer; it does not address all of the risks captured in a foreign currency rating.

The foreign currency rating, in contrast, addresses an entity’s ability to repay foreign currency—denominated debt. In assigning the foreign currency rating, the rating agency takes into account the risk that the government of the entity’s home country may introduce restrictions on the ability to obtain foreign exchange and service debt offshore.

Globalization, the growing sophistication of local banks and companies, attractive business opportunities, and higher yields in emerging markets have resulted in increasing investor interest in these new markets, creating potential new funding sources for companies and banks in these countries. This in turn has led to a significant increase in the number of entities that seek a rating by an
international rating agency. However, even as large emerging market companies and banks increasingly obtain ratings, these companies are constrained by their home country’s sovereign rating. Therefore, absent some type of enhancement, these entities are still unable to access capital from international investors who require an investment-grade rating.

For example, an A-rated issuer in a BB-rated country would typically not be able to pierce the sovereign ceiling and hence would not be able to benefit from the high domestic rating of its foreign currency debt. It would have to pay a high premium to obtain funds from international investors and would be excluded by investors requiring investment-grade ratings. This is a particular problem in large economies that are home to well-established, large, and well-run companies and banks that have long histories of successful operations but in which the domestic capital markets are not able to supply adequate funding. Examples include Argentina, Brazil, Mexico, Turkey, and certain Central American countries.

Over the last several years, companies with high local currency ratings have benefited from different structures designed to pierce the sovereign ceiling. These structures have enabled these companies to successfully tap the international capital markets, thereby broadening their investor base. Examples of such structures include transactions backed by export receivables, transactions involving multilateral agencies using rolling reinstatable guarantees, B-loan structures, and transactions enhanced by political risk insurance policies. Political risk insurance policies have to date been used mainly by issuers in Latin America and Turkey.

**Mechanics of a Transaction Enhanced by Political Risk Insurance**

In very simple terms, a political risk insurance policy mitigates country risk by making funds available for timely debt payments while a T&C event exists. This mitigation allows the rating of the insured security to pierce the country’s foreign currency ceiling and be rated up to the same level as the issuer’s local currency rating for domestically issued securities.

A foreign currency rating of a private sector issuer’s unenhanced debt obligations is typically capped by that of its sovereign. In the case of a security enhanced by political risk insurance, the insurance provider mitigates country risk by making available funds for timely debt payments on the insured notes or bonds if, due to a
The political risk insurer is obligated to pay compensation only if the reason for the nonpayment is the inability of the issuer to obtain foreign currency or transfer such currency in order to make the scheduled payment. The policy would not address a failure to pay that is due to a credit reason or other events.

A political risk policy does not enhance the underlying creditworthiness of the issuer, it only increases the probability that the holder of the insured securities will receive the scheduled payments in a timely manner during a T&C event. Therefore, while a policy can raise the rating of the issue up to the local currency rating of the issuer, it will not enable an issue to obtain a foreign currency rating higher than the local currency rating of the issuer. For subordinated debt, the foreign currency rating of the debt will not exceed the issuer’s local currency rating for its debt at a similar subordination level.

What Factors Influence the Rating Enhancement a Political Risk Insurance Policy Provides?

A political risk insurance policy allows an issue to be rated up to but not higher than the local currency rating of the issuer. The extent to which the policy enhances the foreign currency rating of the issue and how much coverage is required are generally determined by the rating agencies, based on a number of factors. Examples of factors that affect coverage levels include the likelihood and duration of a T&C event, the amount of insurance available to the holders of the security, the tenor and repayment schedule of the underlying transaction, the conditions that would have to be met for the policy to respond, and the ability and willingness of the insurer to meet its obligations under the insurance policy in a timely manner.

The specific methodology for deciding how much of an enhancement can be achieved and how to get there varies across rating agencies, whose rating methodologies and models are proprietary. The rating agency that has been most active in terms of ratings of political risk insurance-enhanced bonds to date is Moody’s Investor Services, but both Standard and Poor’s and Fitch have also rated such transactions. Below is a general discussion of the factors that affect the rating enhancement obtained through political risk insurance.
Likelihood of a T&C Event Interrupting Debt Service

The risk of a T&C event, prompted by a lack of foreign exchange or by government interference that prevents an issuer from meeting its foreign currency obligations, is very similar to and often equates with the probability that the sovereign will default on its own foreign currency obligations. Since the probability of interference increases as the tenor of the transaction lengthens, the probability assigned to a T&C event is cumulative.

Expected Duration of a T&C Event

Rating agencies use different methodologies to determine the expected duration of a covered event, but there are also differences across jurisdictions. Moody’s, while retaining its case-by-case approach, generally does not expect an event to last more than 18 months.122 Sovereign’s experience has been that rating agencies typically require 18 months’ worth of debt service coverage for Latin American issues and 24 months for Turkey. In calculating the expected duration of an event, Moody’s also assumes that once the event is over, foreign exchange will again be available and normal debt service will resume without further government interference.

Rating agencies also consider the probability of a T&C event occurring more than once during the tenor of the transactions. Depending on the country and the tenor of the rated issue, rating agencies may require that the coverage be reinstatable in order to allow maximum rating enhancement. In Sovereign’s experience, an issue with a tenor of more than 10 years requires a reinstatement provision in the policy.

Type of Coverage Provided and the Conditionality of Coverage

Another important factor in determining the enhancement provided is the conditionality of the insurance policy and how the policy would respond in a claims situation. The objective is to ensure the timeliness of payments of the underlying transaction.123 Typically, political risk insurance policies have a waiting period before a claim is paid; in order to ensure timely payments, a supporting mechanism, usually in the form of a debt service account established at the closing of the transaction, is used for the first claim payment. Political risk insurance policies also typically contain exclusions to payment and termination events should the insured party or the issuer fail to
comply with certain contractual obligations. Rating agencies therefore carefully analyze the insurance policies to make sure that the level of coverage afforded is consistent with the rating provided.

**Probability of an Insurer Meeting Its Claims Payments Obligations**

In evaluating the enhancement provided by an insurance policy, rating agencies also evaluate the ability and willingness (including the claims payment record) of the insurer to pay claims that would result from a T&C event in a timely fashion.

**Amount of Debt Service Coverage Required**

In deciding how much coverage is needed to obtain the maximum enhancement, the payment pattern of the insured transaction is also taken into consideration. The policy needs to cover all payments during the expected duration of any T&C event. The expected timing of the event will also influence the amount of required debt service coverage. Should the debt amortize, the amount of coverage required would need to cover both principal repayments and interest payments for the expected duration of the T&C event.

Most of Sovereign’s transactions have been structured with a bullet repayment of the principal, allowing for a time lag between the expected maturity and the legal maturity, during which the principal repayment can be delayed for a period equivalent to the expected duration of a T&C event. By structuring the issue in this fashion, political risk insurance support is required only for interest payments for the duration of the issue, which results in a lower amount of coverage required relative to an amortizing security.

**Advantages of Political Risk Insurance Coverage**

Several benefits are associated with using political risk insurance to enhance ratings for emerging market issues. The key benefits include lower cost for the issuer (a higher rating translates into lower borrowing cost), access to a larger investor universe for the issuer (a higher rating on the securities allows investors requiring a minimum rating to invest in the security), and greater portfolio diversification for investors (a higher rating makes additional securities available to investors requiring a minimum rating).

Issuers that have been able to take advantage of the rating enhancement have demonstrated the effectiveness of using political
risk insurance with meaningful upgrades, and they have achieved interest rates well below those of the sovereign for similar maturities. One example is Banco Bradesco S.A., which in 2003 issued a $500 million bond raising tier-two capital. This issue received a spectacular seven-notch upgrade over the sovereign ceiling of Brazil with the benefit of a political risk insurance policy provided by Sovereign covering 18 months worth of interest payments. In addition, despite being subordinated debt, the issue was priced very competitively. More recently, Finans Bank A.Ş of Turkey issued subordinated debt for 10 years, at a rating level two notches higher than that of the Turkish government, also at a very competitive interest rate. In this case, Finans Bank’s debt benefited from 24 months’ worth of coverage from Sovereign.

Conclusions

The use of this specialized form of political risk insurance to enhance debt issues enables companies and banks domiciled in sub-investment-grade markets to pierce the sovereign ceiling and achieve investment-grade ratings. Doing so increases their access to international investors and alternative funding sources and lowers borrowing costs. From the perspective of an investor, the higher rating allows for greater diversification. The adaptation of the more traditional political risk insurance coverage has become an accepted structure for piercing the sovereign ceiling, and investors and rating agencies now have substantial experience with regard to this product.

Notes

120. Issuers with a substantial portion of their revenues generated by exports, strong issuers in dollarized economies, and issuers benefiting from the support of an offshore partner or multilateral are sometimes able to pierce the sovereign ceiling.

121. See the reference list at the end of this paper for articles published by the major rating agencies on the methodology for rating securities enhanced by political risk insurance.


123. “Traditional” political risk insurance policy covering T&C risks differs from a capital markets policy in terms of the date-certain claim payment and the obligations of the insured party. Since one of the primary objectives of the policy is to ensure timeliness of scheduled debt payments, the claims process and the procedures for paying claims are tighter than in a traditional policy. In terms of the obligations of the
insured party, a capital markets policy is drafted to accommodate the fact that the trustee (usually the insured party) has very limited ability to perform the obligations normally required by the insured. Therefore, many of these obligations are transferred from the insured to the issuer, and these obligations are usually set out in a separate agreement between the insurer and the issuer.

References


Currency Transfer and Convertibility Coverage: An Old Reliable Product or Just an Old Product?

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At the time of the 2002 MIGA-Georgetown Symposium, the dust was beginning to settle following the economic meltdown in Argentina, and the Argentines and the markets were sifting through the ashes trying to figure out how to reestablish some sense of stability and predictability in the economy. Indeed, many companies and investors are still in a protracted process of managing the fallout from the crisis. The consequences in Argentina of those events are well known and include a reduced standard of living, unmanageable debt, a loss of confidence, and an uncertain future. The consequences for foreign investors and financial institutions are also well known: a new regulatory environment that affected operations and balance sheets. But there were still other consequences of the crisis in Argentina. We refer to what appears to be an unprecedented level of skepticism, especially among financial institutions regarding the value of currency inconvertibility coverage provided by underwriters of political risk insurance resulting from a perceived failure of the product to respond to events in Argentina.

This paper begins with a brief review of currency inconvertibility (CI) coverage. It then considers the extent to which CI is still a risk worth insuring. We then discuss the traditional uses and users of the coverage, before analyzing the criticisms that have been raised about the product. We then look at some of the ways in which the market has responded to these criticisms, before closing with a look at an opportunity for some innovation that could reinvigorate CI coverage.
Currency Inconvertibility Coverage: The Basics

CI coverage has been around for many years. Of the three main perils insured by political risk underwriters—currency inconvertibility, expropriation, and political violence—it has been the most tested but the least changed. Aside from political violence damage coverage, it is, at least in theory, also one of the least complicated coverages.

In its simplest form, CI coverage protects against the inability to convert local currency into a particular foreign currency and remit those funds outside the host country, provided that the insured or the borrower attempted to convert and remit the funds for the duration of a specified waiting period using all legal mechanisms available. Currency devaluation is typically a standard exclusion in the coverage, because this risk has long been assumed to be a commercial risk and because it has traditionally been deemed a business risk reflective of the general ebb and flow of the local economy rather than a pure political risk in the most traditional meaning of the word. An important aspect of CI coverage is the underwriter’s ability to have clear and unencumbered subrogation rights to the underlying payment obligation and the blocked funds.

Does Currency Inconvertibility Still Exist and Is It Worth Insuring?

Post–World War II history is replete with examples of economic and foreign exchange crises that directly affected the ability of foreign investors and creditors to transfer their profits to their home countries. Between FY1966 and FY1993, OPIC settled CI claims in all but three of those years, paying out more than $112 million. After 1993 there was a lull in the flow of CI claims. But the crises in Russia and Asia in the late 1990s, and more recently the events in Argentina (2001), Venezuela (2002), and the Dominican Republic (2004), suggest that the risk of currency inconvertibility remains a concern. And while many Central and Eastern European countries have leapfrogged other developing countries in achieving remarkable progress toward creating market economies, many countries in Latin America, Asia, Africa, and the former Soviet Union still face fundamental structural economic problems that portend continued uncertainty and instability. These forces are sustained by the advent of democracy throughout much of the developing world, which means that governments, and therefore economic policy making, in emerging markets will face the
additional pressures and associated uncertainty of domestic politics at each election cycle. So the question at hand is not whether the risk of currency inconvertibility exists but whether the political risk insurance market can provide a viable product that adequately protects insureds against that risk to the point where they are willing to pay a premium for it.

### Who Buys Currency Inconvertibility Coverage and Why?

For many years the private insurance market treated CI coverage with some caution, and it was not uncommon for that coverage to be offered under a sublimit or lower indemnity than for, say, expropriation. In the late 1990s the private political risk insurance market expanded substantially, fueled in part by large, previously unheard of line sizes and long tenors provided by the corporate market. Additional capacity from export credit agencies and multilateral entities provided additional impetus to the growth of political risk insurance.

Concurrent with this was a boom in foreign private investment flows to emerging markets, much of which was targeted at countries struggling to cope with growing demands on their inadequate and antiquated infrastructure. With that came a renewed interest on the part of banks in using political risk insurance, particularly CI coverage, as a valuable risk mitigation tool. As a result, international banks became some of the largest users of political risk insurance, and whatever concerns there may have been about the value of CI coverage up to that point were put back in the closet.

For banks, a critical concern was the availability of CI coverage (and in some cases expropriation of funds). Backed in some cases by their regulators, banks developed policies for managing their cross-border risk that allowed them to avoid counting against their country lending limits those exposures that were insured for CI. Buying political risk insurance became a matter of the transactors at the banks confirming to their credit committees that a given transaction would be covered by CI coverage. Thus CI coverage provided tremendous leverage to the banks, helping them expand their lending, better serve their customers, and remain competitive.

CI coverage has also been particularly valuable in the capital markets. Financially strong corporate bond issuers in emerging markets, whose access to the capital markets is constrained by the sub-investment-grade ratings of their sovereigns, have sought to attach CI coverage to their bonds. The rating agencies have become
comfortable with the strength of protection afforded by this coverage, and they have been willing to pierce the sovereign ceiling and boost the bond rating to the equivalent of the corporate rating.

In the meantime, CI coverage has continued to be a mainstay for many equity investors, who invest tremendous amounts of capital in, and make long-term commitments to, emerging markets. In many cases, their ability to repatriate their profits as well as periodic dividends over the long term is fundamental to the viability of their investments. CI coverage can provide the comfort necessary to ensure the returns on their investments to their shareholders.

Currency Inconvertibility Coverage under the Microscope

It is useful to review what transpired in Argentina to understand the basis for the growing skepticism about CI coverage. In the second half of 2001, a protracted period of economic contraction in Argentina, exacerbated by a series of changes in the country’s leadership over a brief period of time, led to dramatic social, political, and financial turmoil. This culminated in a number of fundamental changes in economic policy that had far-reaching consequences. These changes included abandonment of the peso-dollar peg at 1:1, which had been in place since March 1991, resulting in a significant devaluation of the peso; the suspension of payments on most of Argentina’s sovereign debt; mandatory conversion of certain U.S. dollar-denominated debts into peso-denominated debts; the conversion of U.S. dollar bank deposits into pesos at an overvalued exchange rate (compared with the devalued rate); the prohibition on adjusting certain utility tariffs in accordance with changes in U.S. inflation, as had been provided for in some concessions; the renegotiation of public utility contracts; and other measures. Most relevant to purchasers of CI coverage was the imposition of exchange controls, which introduced new restrictions on the remittance of funds outside of Argentina.

Faced with all this it is perhaps not surprising that expectations were high that there would potentially be many losses in the political risk insurance market. And judging from what information is publicly available, some CI claims were paid. In other cases, insureds were able to avoid exchange controls (and thereby avoid having to file CI claims) by virtue of an exemption to the controls granted to transactions insured by members of the Berne Union (such as Zurich). So what, then, is the basis for the growing cynicism about CI coverage?
The real culprit in many of the losses that were incurred in Argentina was the end of the peso-dollar peg and the devaluation of the local currency. Many borrowers in Argentina were no longer able to service their external hard currency debts with a devalued peso and thus defaulted on these obligations. Clearly, this was a financial and commercial crisis, not a political one, at least within the terms of most political risk insurance policies. Senior management in many financial institutions who were far removed from the process of procuring political risk insurance were under the mistaken impression or simply assumed that devaluation was covered in their political risk insurance policies, when in fact it is an explicit exclusion. When some political risk insurance policies did not respond to the collapse of the peg in Argentina, the common refrain from the financial services sector was (perhaps not surprisingly): “If this is not currency inconvertibility, what is?” As a result, it seems that the events in Argentina convinced many purchasers of CI coverage that devaluation is the real risk they face in emerging markets, and since this is a commercial risk that is excluded in most political risk insurance policies, CI coverage as a whole was judged by some not to be an appropriate or cost-effective way to manage their cross-border currency risk.

Talking to many bankers and brokers who were familiar with the product, one could easily come to the conclusion that the Argentine crisis was the last nail in the coffin of CI coverage, and that it is no longer a viable product. They assert that what appeared to many to be a quintessential event of currency inconvertibility did not result in the flood of paid claims that one might have expected after what happened in Argentina.

Several other causes have been cited as fueling the growing skepticism by those who share the view that CI coverage as we have come to know it is dead and buried. Some observers have claimed that the buyers of political risk insurance did not know what they were buying, a subtle implication that either the underwriters did a poor job of explaining the coverage or the buyers were not sophisticated enough to negotiate CI coverage that would have responded to the events in Argentina. Our experience, however, is just the opposite. Political risk insurance policies are typically heavily manuscripted and often involve detailed negotiations with transactors (and often their lawyers), who are very familiar with the product. The portrayal of the insureds as naïve players is not consistent with how the purchasing process works.
Another criticism that has been leveled is that underwriters, facing potentially huge losses, were determined to avoid paying claims or at least to minimize them. It is an axiom in the industry that underwriters’ reputations can rise and fall with the perceptions of their ability and willingness to pay claims. This is a powerful incentive for an underwriter not to delay or deny valid claims. At the same time, it does not make commercial sense for underwriters to pay or settle claims simply to avoid the untidiness of having to litigate or arbitrate what they believe is an invalid claim.

Yet another assertion made is that at least some underwriters got lucky by virtue of the exemptions to the foreign exchange controls they received from the government of Argentina as members of the Berne Union. But that argument misses the point. Most users of insurance buy it hoping they never have to use it. And the fact is that Argentina insureds who bought coverage from members of the Berne Union were able to overcome the exchange controls. That they were better off having bought the insurance than if they hadn’t—or had instead bought it from a non-Berne Union member—is clear.

This is not the first time that CI coverage has come under the microscope. In the early 1980s Venezuela faced a deteriorating economic situation that eventually led the government to introduce a multitiered exchange rate system making hard currency available at preferred exchange rates below the market exchange rate. Borrowers were not prevented from servicing their debts and had several options available to them, including using the less favorable market exchange rate. Under these circumstances some export credit agencies assessed claims under the insurance policies they had issued as commercial rather than political risk losses and paid the correspondingly lower indemnity percentage that applied to commercial claims. The Argentine crisis in the 1980s also raised questions in the market about CI coverage because of the case made by underwriters that, notwithstanding the difficulties involved in converting and remitting funds abroad during those troubled economic times, there still existed legal mechanisms for doing so (e.g., government-issued BONEX bonds).

The Problem Today

We could go on at length discussing the merits of these and other arguments that condemn CI coverage to the garbage heap. The fact is—and this is something on which underwriters, brokers, and
buyers can all agree—there is a belief in the market, or at least among financial institutions, that CI coverage is not everything it is cracked up to be. Moreover, the perceived failure of the coverage has damaged the credibility of political risk insurance as a risk mitigant. Indeed, the damage to the product may be compounded by the fact that some questions have also been raised about the responsiveness of expropriation coverage in Argentina, although here the issues are much more complicated and the jury is still out on some of the large, more complicated claims. There is no denying the impact of this drop in confidence: the flow of inquiries from financial institutions for conventional CI coverage is down sharply, and the demand for nonhonoring coverage (i.e., coverage for cross-border sovereign payment risk) and comprehensive credit insurance is increasing noticeably.

It is not surprising that the financial services sector is at the center of this debate. Banks have been one of the principal engines driving the growth in political risk insurance over the past 10 years, and the fuel for this engine was CI coverage. While the coverage itself has come into question by banks, we have not seen a drop in demand for coverage from equity investors. In fact, requests for political risk insurance from companies from the manufacturing, natural resources, and services sector are increasing. That said, CI coverage is important, but it is not the primary concern of many investors in the nonfinancial services sectors. And it would be a leap of logic to assume that the increase in demand for coverage of equity investments is proof that the rumors of CI’s death are highly exaggerated. Nevertheless, it would be a mistake to assume that because CI coverage is not as important for equity investors as it is for banks, the basic underlying criticisms of the coverage are irrelevant.

**Service Innovation**

How is the insurance market responding to this problem? Product innovation is one way, as discussed later in this paper. But there are other ways that underwriters can maintain interest in CI coverage.

The current debate about the value of CI coverage sidesteps an important feature of the service provided by underwriters, namely, their willingness and ability to intercede when events occur in a market that have the potential for maturing into claims. The clearest example of this was in Argentina, where a few private underwriters (in addition to many export credit agencies) were able to leverage their membership in the Berne Union for the benefit of their...
customers. Underwriters were able to pass on to their insureds the benefit of exchange control exemptions that the government of Argentina granted to Berne Union members. As a result, their customers were eventually able to remit their funds abroad and did not have to call on their insurance policies.

A more recent example of the role underwriters can play in loss mitigation is Venezuela. In this case, as of this writing, underwriters do not benefit from a Berne Union exemption like the one granted in Argentina. But some of them, including Zurich, have taken a proactive approach in helping their clients work through the new foreign exchange controls and bureaucracy. These efforts have produced tangible results for their clients, in a number of cases enabling them to successfully remit their investment returns outside of Venezuela.

In sum, the notion of a political risk insurance underwriter as simply an issuer of policies and a payer of claims is changing. The premium insureds pay buys more than just a promise to pay for losses covered under the policy. But this alone does not address what are perceived to be some flaws in CI coverage as it is currently offered.

**Product Innovation**

It may be that with time, as the memory of Argentina fades and markets recover from their losses, interest in CI coverage will be rejuvenated. But simply waiting for this to happen may be wishful thinking. The level of skepticism about CI coverage in the financial institutions market seems to have reached a critical mass that requires new thinking and innovation.

Recently, the market has begun to explore ways of addressing what were and still are considered to be some of the principal shortcomings of CI coverage. The first target in the line of sight was devaluation risk, a standard exclusion in CI coverage.

The first serious attempts to provide coverage against devaluation risk started before the crisis in Argentina. These efforts focused specifically on an insured’s exposure to the currency mismatch found in many infrastructure projects (particularly power) that sold their product in local currency to local offtakers (typically sovereign or quasi-sovereign) at prices linked to the exchange rate of a specific foreign hard currency but financed with huge amounts of hard currency. This financing model worked until changes in inflation and exchange rates strained the financial resources of the offtakers,
which found it politically untenable to pass the necessary price increases on to their customers. As a result, in some cases they could not meet their obligations, leading certain projects to default on their foreign debt.\textsuperscript{124}

OPIC is credited with closing the first policy designed to address this devaluation risk. However, very few transactions in the public domain have been able to take advantage of this development. There are several reasons for the lack of success for what otherwise was a significant breakthrough. First, the coverage makes sense only for certain types of projects and countries, such as projects in which cash flows and local currencies are strong, long-term offtake contracts that are tied to domestic inflation, and countries with relatively stable floating exchange rates and a stable economic and regulatory environment.

Second, the coverage as structured by OPIC is more akin to a guaranty, and political risk insurance insurers are wary of offering a product that could be construed as a guaranty rather than insurance. In the simplest terms, an insurance policy is a conditional obligation to pay, whereas a guaranty is an unconditional obligation to pay. Guaranties and insurance products are generally governed by different regulations; require different capital structures; and are issued by underwriters with different kinds of expertise (so-called monoliners, in the case of guarantees). Moreover, they are often supported by reinsurers that also make key distinctions between the two products. Thus it is important for political risk insurance underwriters to steer clear of issuing guaranties.

Third, developing the product is a time-consuming and labor-intensive process that may require the use of outside expertise. Political risk insurance underwriters are not averse to investing these resources in a product if they believe the pay-off is justified. But so far so-called “devaluation insurance” in its current form has not proven to be the panacea some might have hoped for. Nonetheless, this has not deterred the market from continuing to evaluate the potential for developing a product to cover devaluation risk that will have wider application and acceptance in the market.

**Improving CI Coverage**

One of the chief objections raised about how traditional CI coverage works in practice is the requirement that insureds or borrowers access all legal means available to them in the host country for converting and remitting funds abroad as a condition for making a
claim under the policy. In a number of recent cases, the imposition of exchange controls in emerging markets posed significant obstacles to what previously had been a routine (albeit at times cumbersome) conversion and remittance process, but even after controls were established, there still existed other less conventional ways to convert and remit funds externally. The policies issued by the underwriters require insureds to access these channels, even though they may be more cumbersome and costly than the traditional methods used. Faced with this requirement, many insureds may decide that coverage is no longer worth buying.

This aspect of CI coverage has been and continues to be viewed as a major shortcoming. Can the insurance market address this problem in a way that can reinvigorate interest in CI coverage? One possible solution is to modify the standard CI coverage such that after an event of currency inconvertibility, insureds would be required to access only what in that particular country had been or continued to be the official or traditional legal mechanisms for converting and remitting currency. In other words, the insured would not be required to access more exotic and indirect means for converting and remitting funds. Of course, the insured would still be required to attempt to convert and remit in accordance with the laws and regulations of the host country for a specified waiting period, including whatever new rules and procedures that may have been put in place as part of the exchange controls. The underwriter would still retain the all-important subrogation rights to any blocked payments to maximize its recoveries after payment of a claim.

This enhancement of CI coverage would most likely come at a higher price than more traditional coverage. It may also necessitate a longer waiting period than is typically offered, and it may not be available in every country all the time. Nonetheless, this would be a significant improvement in CI coverage and an example of how the market could adapt to changing circumstances for the benefit of its customers. Such a development could also help revive CI coverage as a viable product in the eyes of financial institutions.

**Conclusion**

CI coverage appears to be at a crossroads. As in the 1980s, a series of crises in emerging markets has focused new scrutiny on the use of political risk insurance as a way to manage cross-border risk. With that scrutiny has come a determination by some insureds that the coverage may not be living up to expectations and that in its
current form it does not provide the breadth of protection needed to justify the cost.

This raises the question about what the future holds for CI coverage. We believe that CI coverage, even in its current form, provides protection against a real risk in emerging markets that continues to be a concern to investors and financial institutions. We also believe that the willingness and ability of underwriters to become actively engaged, in partnership with their insureds, to deal with potential events of currency inconvertibility with a view to minimizing if not eliminating, losses is a valuable but often overlooked benefit of CI coverage. However, we also appreciate the perceived shortcomings of the coverage. Political risk insurance underwriters need to take this to heart and consider ways to enhance existing products or develop new products that can bridge the coverage and expectations gap that currently exists in the market.

Note

Discussion of New Products and New Perspectives in Political Risk Insurance

Symposium Panelists and Participants

The discussion was wide-ranging and extended beyond currency transfer and convertibility coverage. It included a discussion of the meaning of “all legal means to convert” and who should take any “haircuts” (losses) under different currency conversion circumstances; credit rating agencies and credit enhancement coverages; and terrorism, political violence, and war risk coverages.

Alternative Mechanisms, “All Legal Means to Convert,” and “Haircuts”

Question: What does it mean that an underwriter expects the insured to take “all legal means” to gain access to dollars?

Riordan: The policy language for currency inconvertibility coverage is rather clear and simple. It is one of the least complicated kinds of political risk insurance coverage, requiring the insured to access all types of legal channels to convert and transfer dollars. The insured is not expected to do anything illegal or to go to the black market. These legal channels can take different forms in different countries, such as the Brady-bond market in Argentina and the Venezuelan stock and bond markets.

Under the enhancement of CI coverages referred to in my paper, accessing these channels would not be required. All that would be required would be to access the official exchange market. If it were closed beyond a declared waiting period (typically 180 days), it would be the insurer’s understanding that a legitimate claim could be made.
Question: If the insured follows all legal means and this eventually results in a haircut, does the insurer then share pro rata in the loss that comes from using the channel?

Riordan: Under the two scenarios already laid out, with traditional coverage the insured would take the haircut and the insurer would not. With the enhancement, the insurer would take the haircut.

Question: To take an example from Venezuela, the insured may want to sit and see if things improve, and when the end of the waiting period comes, the insurer should pay the claim. But if the insurer says that it does not have the time or patience to wait until the end of the waiting period, perhaps six months, the insured should look for an alternative legal route as a jointly agreed method of minimizing the loss. In this case, why shouldn’t the insurer share the haircut on a pro rata basis? There have been private political risk insurers in Argentina that have been willing to share haircuts with insureds. So why would Zurich not do the same, without introducing some new enhanced product?

Riordan: To answer in a general way, Zurich, as a major underwriter, is not afraid to use its clout, and join with others, to try to deal effectively with the government and to find a way for the insured to be protected so that loans are paid on time, dividends are paid on time, and funds are transferred and converted. That is an important service Zurich provides as part of its insurance product. In Venezuela delays have not exceeded the waiting periods or been longer than 30 days.

Question: What was unusual about what went wrong in Argentina between insured and insurers on inconvertibility coverage? Twenty years ago OPIC paid claims in Argentina, essentially not realizing that there was a possibility of a legal parallel market. The language “any legal channel” was added to the contract then, and adopted by others, to avoid essentially guaranteeing an official rate that would have been devaluation coverage, which insurers did not want to give. Typically, the legal channel just meant an alternative means of obtaining foreign exchange at a market-generated rate as opposed to the artificial, unsustainable official rate, so there will be a haircut, the difference between the artificial rate and the market rate. But did something worse go wrong? Nobody intends to force insureds to
buy and sell strawberry jam on the world market to earn dollars. Was there something more unusual that went wrong in Argentina that insurers should be careful of?

*Riordan:* In Argentina in the 1980s there was the Brady-bond market as a means of obtaining dollars, with a haircut. But there may have been a very basic misconception about what this product provided. The words “all legal means” are there for a reason, because underwriters have an expectation that the insured will use whatever means are available. The insurer is not providing devaluation coverage in these policies. That is an excluded event. There was a very basic misunderstanding by some of the buyers, and that misunderstanding led to a gap between buyers and sellers of insurance that led to disputes and difficulties. More recently, in Argentina, there was the benefit provided to Berne Union members who, in a sense, became preferred creditors and were able to pass that advantage on to their insureds. A problem arose for banks that did have the exception and were not blocked, but because of the dramatic economic decline in Argentina, many of the corporate borrowers just did not have the local currency to even attempt to convert and transfer. In some cases there was an unfortunate view that the CI policy had failed, because there was a presumption that it was more comprehensive and should have covered this situation.

*Comment:* In Argentina many clients wanted a tool to be able to avoid provisioning, and they obtained it. They also wanted to pay as little as possible for a very scaled-back product, which was the currency inconvertibility policy. In hindsight it is easy to say that they should have bought comprehensive coverage that covered both the commercial and the political risk, but this was not done. Is that really the product’s fault? The fallout from Argentina has not been as much as that from Venezuela, because the Berne Union exemption to the exchange controls came for the most part—at least with private insurance—within the waiting period. So the bulk of the claims that might have emerged in Argentina did not occur. What has happened in Venezuela is that the insurers said insureds could buy ADRs (American Depository Rights), sell them in New York, and obtain dollars. Insureds never envisioned that they would have to use these kinds of mechanisms to gain access to dollars, but none of their claims has been honored.
Riordan: When underwriters assume a risk, they expect under the terms of the policy that insureds will act as sophisticated investors or sophisticated financial institutions to try to use whatever means they have to try to effect conversion and transfer. Some of these means are exotic, some are unconventional; but they are not illegal or impossible. In Argentina there was the Brady-bond market. In Venezuela there was the use of ADRs and other bond issues. The expectations of the insurers is that insureds would use whatever means they can to effect conversion and transfer in markets that undergo a lot of instability from time to time.

Credit Rating Agencies and Credit Enhancement Coverage

Question: Given the loss of faith in the currency convertibility product post Venezuela and Argentina, have the rating agencies expressed the same faith in the currency inconvertibility mechanism that Sovereign provides, or are the rating agencies reconsidering the product given that there is a requirement that expensive alternative channels for conversion be used?

Westholm-Schröder: The rating agencies have not changed with respect to Sovereign’s CI policies. The local currency rating is designed to pick up operational risk, regulatory risk. The rating agencies are aware that T&C coverage is extremely narrow, designed to cover a specific part of country risk. Indeed, S&P published an article after Argentina, basically saying that the policies are responding the way they expected them to respond. So I expect them to continue to give credit to Sovereign’s CI coverage.

Question: Banks like to know for sure when they are going to get paid or not get paid. Could the time limits of payment that exist in currency convertibility for capital markets also be offered to banks?

Westholm-Schröder: In comparing CI coverage for capital markets with traditional CI coverage for lenders, there is a 180-day waiting period, but the claims determination period is built into that 180 days, so it is fast moving. In principle, that could be made available for lenders, for a price. There is a certain price associated with the unique nature of how the claims are handled, how the determinations are made, and whether there is an accelerated period. But depending on the market and depending on the risk, a policy could be written.
Question: How much analysis does the credit rating agency conduct on bond issues that are able to pierce the sovereign ceiling because of 18 or 24 months of inconvertibility coverage? Specifically, do the rating agencies undertake stress testing on the borrower, looking at what their foreign currency obligations are or will be? Or in the event of a 50 percent devaluation, for example, will the borrower still be able to meet its debt service?

Westholm-Schröder: Probably the answer is yes, but this is part of the black box of rating agency analysis. There is the same risk for a domestic issue, if the company has dollar obligations or if the company must pay for imports.

Comment: But if a lender is making a cross-border loan in a foreign currency and the borrower does not have a natural hedge in foreign currency to service that debt, this is not the same as lending local currency, because if there is a devaluation, there is a commercial event that is not going to be covered by a political risk insurance policy.

Riordan: In Zurich’s experience the rating agencies estimate how long a catastrophic convertibility event might last in a given market to determine the amount of coverage that will be necessary—18 months, 24 months, or in some cases 36 months. These estimates could be different in Brazil and Turkey, even though the country ratings may be the same. The rating agencies use historical data, looking at the potential for a catastrophic devaluation and how long the crisis would last. Some capital market transactions extend longer than 10 years, going out to 15 years. In such cases the rating agencies suggest that there may be a need for more coverage or some sort of reinstatement of coverage over time, anticipating that, for example, maybe over 10 years there will be one major catastrophic event that could last 18, 24, or 36 months, but over 15 years there could be two. So there are likely to be demands for even more coverage, particularly on long-term capital market transactions.

Westholm-Schröder: In Sovereign’s experience, there is no guarantee that if a company is AA rated in Brazil, the transaction will receive an AA rating via insurance. That is not a given. The transaction may get a single A, taking into consideration the risk over the life of the transaction.
Terrorism, Political Violence, and War Risk Exclusions

*Comment:* A major new element in the industry today is insurance of nonrecoverable political risk, meaning political violence or war risks. In the Lloyd’s market, three years ago political violence coverage represented 8 percent of traditional political risk insurance covers, today it represents 160 percent of the premium of traditional political risk insurance covers. A lot of this is stand-alone political violence cover, written by specialist political risk underwriters.

*Riordan and Westholm-Schröder:* Zurich sees a demand for political violence coverage, and it has started providing stand-alone political violence cover. Sovereign estimates that the growth will be in terrorist insurance, designed to cover a terrorist event, not the traditional political violence.

*Comment:* A lot of the growth in political violence coverage is terrorism cover. But coverage of political violence in emerging markets requires making adjustments in the traditional war exclusion, which only specialist political risk underwriters at Lloyd’s are allowed to do. A terrorism-only product with full war risks exclusion is a war risks exclusion; what that has meant for 300 years in the London market is that this product is not a viable product. What is needed is innovation with respect to this coverage. It is a big opportunity, and it is going to happen.

*Comment:* The vast leap in the proportion of political violence income to income from traditional political risk coverages is almost solely a result of terrorism risk. Before September 11, very few people bought stand-alone terrorism coverage outside of a few countries.
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Frederick E. Jenney is a partner in the Washington, DC, law office of Morrison & Foerster LLP, where he is member of the firm’s Project Finance and Development Group. His practice focuses on international project finance, political risk insurance, and cross-border investment transactions, with an emphasis on structuring, lending, political risk, and intercreditor issues.

Mr. Jenney has represented lenders and developers in project financings in Asia, Latin America, the Caribbean, and Central and Eastern Europe, principally in the power, water, hotel, manufacturing, and telecommunications industries. Before joining Morrison & Foerster, he served as Assistant General Counsel of OPIC, where he represented OPIC as senior lender and political risk insurer in a broad range of project finance, equity fund, and cross-border investment transactions worldwide.

Mr. Jenney’s project finance experience comprises new loans, refinancings, restructurings, and workouts for projects ranging in size from $2 million to $2.5 billion, particularly with respect to co-lending among multilateral and bilateral agencies (OPIC, the U.S. Eximbank, the Inter-American Development Bank, the Japan Bank for International Cooperation, the International Finance Corporation, and the European Bank for Reconstruction and Development); commercial bank syndicates; and 144A lenders. Mr. Jenney’s political risk insurance experience encompasses both insurance and reinsurance of a broad range of equity and debt investments by developers, commercial banks, and capital markets investors.

Mr. Jenney has served as an adjunct professor at the Georgetown University Law Center and the George Washington University National Law Center, where he taught courses on FDI, international commercial transactions, and international project finance. He received his B.A. from Yale University in 1979 and his J.D. and
M.B.A. from the University of Virginia in 1983. Mr. Jenney is a member of the New York and District of Columbia bars.

THEODORE H. MORAN
Theodore H. Moran holds the Marcus Wallenberg Chair at the School of Foreign Service, Georgetown University, where he teaches and conducts research on the intersection of international economics, business, foreign affairs, and public policy. Dr. Moran is founder and director of the Landegger Program in International Business Diplomacy, which offers courses on international business-government relations and negotiations to some 600 undergraduate and graduate students each year. He also serves on the Executive Council of the McDonough School of Business at Georgetown. His most recent books include *The Impact of Foreign Direct Investment on Development: New Measurements, New Outcomes, New Policy Approaches*, which he edited with Magnus Blomstrom (Institute for International Economics 2005); *International Political Risk Management: The Brave New World* (MIGA, World Bank 2004); *Beyond Sweatshops: Foreign Direct Investment, Globalization, and Developing Countries* (Brookings Institution 2002); *International Political Risk Management: Exploring New Frontiers* (MIGA, World Bank 2001); and *Foreign Investment and Development* (Institute for International Economics 1998). In 1993–94 Dr. Moran served as Senior Advisor for Economics on the Policy Planning Staff of the Department of State, where he had responsibility for trade, finance, technology, energy, and environmental issues. He returned to Georgetown after the NAFTA and Uruguay Round negotiations.

Dr. Moran is a consultant to the United Nations, to diverse governments in Asia and Latin America, and to the international business and financial communities. In 2000 he was appointed counselor to MIGA. In 2002 he was named chair of the Committee on Monitoring International Labor Standards of the National Academy of Sciences. Professor Moran received his Ph.D. from Harvard in 1971.

YUKIKO OMURA
Yukiko Omura, a Japanese national, joined the World Bank Group as Executive Vice President of MIGA in May 2004. Ms. Omura brings more than 20 years of international professional experience in the financial services sector. She began her career as a project economist with the Inter-American Development Bank in Washington, DC. She then spent 10 years at JP Morgan, in Tokyo, New York, and London, where her duties included launching the emerging markets operations
in the Tokyo office and heading EMSTAR (Emerging Markets Sales, Trading and Research) Marketing for Northern Europe, out of London.

Ms. Omura joined Lehman Brothers as Head of Emerging Markets, Asia; she subsequently became Head of Credit Business, Asia. She went on to head the Global Fixed Income and Derivatives Department of UBS in Japan. Following a merger with SBC and LTCB, Ms. Omura became the new head of the merged bank but left to join her global partners and become the new head of Dresdner’s Global Markets and Global Debt offices in Japan.

In 2002 Ms. Omura created the AIDS Prevention Fund, a charitable company based in London.

Born in Paris, Ms. Omura was educated in Switzerland and the United Kingdom. She earned a master’s degree in political economics from Boston University.

**ROBERT C. O’SULLIVAN**

Robert C. O’Sullivan is Associate General Counsel for Insurance Claims of OPIC. He provides legal advice and handles claims arising from OPIC’s political risk insurance program, managing OPIC’s dealings with insured investors, other U.S. government agencies, and the foreign government involved. He has also negotiated a number of the intergovernmental agreements under which OPIC operates around the world. Before joining OPIC’s legal staff in 1981, he was an associate in the Washington law office of Sutherland, Asbill & Brennan.

Mr. O’Sullivan has been an adjunct professor at Georgetown University Law Center. He is a frequent speaker at OPIC’s internal training programs and client conferences and at international law and investment meetings. He received a B.A. from Boston College in 1968, a J.D. from Harvard Law School in 1975, and an M.A. in Russian Area Studies from Georgetown University in 1978.

**DANIEL W. RIORDAN**

Daniel W. Riordan joined Zurich in June 1997, to establish and manage Zurich Emerging Markets Solutions, a global political risk insurance group in Washington, DC, that delivers political risk solutions to leading international investors and financial institutions that operate in emerging markets.

Between 1994 and 1997, Mr. Riordan was Vice President for Insurance of OPIC. He managed OPIC’s political risk insurance operations, generating $200 million in premiums for investment coverage in
75 countries. Mr. Riordan also served as OPIC’s Senior Interagency Policy Advisor and as a member of OPIC’s senior management committee, which considers large financing and insurance proposals. He served in several other management positions at OPIC, including Underwriter, Marketing Director, Chief Information Officer, and Deputy Vice President. Mr. Riordan began his career at OPIC in 1982 as an unpaid intern while pursuing his graduate education.

Mr. Riordan received a B.A. from the State University of New York College at Oswego and an M.A. in international development from the School of International Service at the American University.

**CLIVE TOBIN**

Clive Tobin recently assumed the position of Chief Executive Officer of XL Insurance, the insurance segment of XL Capital. His previous position was CEO of XL Insurance Global Risk, the largest commercial account division of XL Insurance.

Mr. Tobin began his career with the accounting firm of Price Waterhouse in London. From 1979 to 1986 he was Vice President of Risk Management Services for Marsh & McLennan, Inc., working initially in Bermuda and subsequently in New York, where he was responsible for global marketing and the implementation of captive insurance programs. In 1986 he joined Rockefeller Financial Services, Inc., in New York as president of Rockefeller Insurance Company; later that year he was also made president of the newly formed Acadia Risk Management Services, Inc., a brokerage and risk management consulting company for the Rockefeller family and associates. He joined XL Capital in 1995 in its Bermuda operations.

**LOUIS T. WELLS, JR.**

Louis T. Wells, Jr., is the Herbert F. Johnson Professor of International Management at the Harvard Business School. He has served as consultant to the governments of a number of developing countries, as well as to international organizations and private firms. His principal consulting activities have been concerned with foreign investment policy and negotiations between foreign investors and host governments.

His research interests include multinational enterprises, international business-government relations, foreign investment in developing countries, and foreign investment by firms from developing countries. In 1994–95 he was the coordinator for Indonesia projects of the Harvard Institute for International Development in Jakarta. He is a Fellow of the Academy of International Business, a member of
the Foreign Advisory Board of the Lahore Business School, and a member of the Council on Foreign Relations. Professor Wells received a B.S. in physics from Georgia Tech and an M.B.A. and D.B.A. from the Harvard Business School.

GERALD T. WEST
Gerald T. West is Senior Advisor to the Vice President and General Counsel of MIGA. Since joining MIGA in 1991, he has held five different positions in four different MIGA departments. Most recently, he served as Director of Policy and the Environment. Before joining MIGA, he served in a variety of positions at OPIC, including 10 years as Vice President for Development. For 10 years (1980–90) he chaired OPIC’s Investment Committee and was a member of its Claims Committee.

From 1983 to 1995 and 2003 to 2005, he served as an adjunct professor of international business diplomacy at Georgetown University, where he teaches a graduate course on international political risk assessment and management. Over the past 25 years, he has lectured, consulted, and published widely on corporate political risk assessment and management. He is the "godfather" of the MIGA-Georgetown Symposium on International Political Risk Management. For nine years he was affiliated with the Foreign Policy Research Institute, where he conducted research on a wide range of international political and economic topics.

Dr. West received a Ph.D. in international politics from the Wharton School of the University of Pennsylvania, and a B.A. from LeMoyne College.

CHRISTINA WESTHOLM-SCHRÖDER
Christina Westholm-Schröder is the Chief Underwriting Officer at Sovereign Risk Insurance Ltd. of Bermuda, a private political risk insurer owned by ACE Bermuda Insurance Ltd. and XL Insurance Ltd. She spent 11 years at MIGA, which she joined as one of its first employees in 1988. At MIGA she worked in several capacities, including Regional Manager for Asia and Latin America and Manager for Syndications and Business Development.

Before joining MIGA, Ms. Westholm-Schröder worked as a political risk insurance broker at Bank of America’s Global Trade Finance Department in New York and at AB Max Matthiessen in Stockholm, Sweden. She has an M.B.A. in international business from the Stockholm School of Economics and Business Administration, as well as an M.B.A. in finance from New York University.
APPENDIX II

Whither the Political Risk Insurance Industry?

Gerald T. West  
Senior Advisor to the Vice President  
and General Counsel  
MIGA

Kristofer Hamel  
Consultant  
MIGA

While most adults have long since forgotten their study of vector geometry, the memory likely remains of two equally strong men pulling an object with a rope while standing at a $90^\circ$ angle to each other, resulting in the object following a path mid-way between them, at a $45^\circ$ angle. The image of multiple, different forces pulling in slightly different directions causing movement in an unexpected direction is probably also in the distant memory of most adults as well. Yet when trying to understand complex phenomenon in the real world that are shaped by many forces, it is tempting and common for many of us to ignore multicausality and to instead seek to identify the strongest force and then assert its primacy in terms of determining an outcome or future trend.

This metaphor seems useful to recall when one considers the question “Whither the political risk insurance industry?” There is a strong temptation to argue deterministically and suggest that the future of the industry will be a product largely of international investment flows, which in turn are related to international economic environments. This approach minimizes the effects of “other forces” on the supply side or the demand side of the international investment insurance industry.

This paper reflects the views of the authors, not those of MIGA or the World Bank Group. The authors are indebted to Lou Wells and Theodore Moran for their comments on an earlier draft.
This paper explores the nexus between the macro and the micro factors that affect this industry. It argues that the industry is not at the mercy of FDI flows but rather is and will continue to be shaped by many other factors and hence can heavily influence its own future development.

The paper begins by discussing the current global and political environment and the state of global FDI flows. It then addresses the common belief that the flow of FDI to emerging markets largely shapes the volume of political risk insurance that is written. Although frequently left implicit, the most common assumption is that the “tidal flow” of new FDI, whether rising or falling, carries the political risk insurance industry upward or downward. After establishing that this does not seem to be the case, the paper examines other supply and demand factors. Based on this analysis, a concluding section discusses trends for future developments in the political risk insurance industry.

The International Economic and Political Environment: Past, Present, and Future Trends

The decade between 1995 and 2004 has been a period of flux for the international investment community. One could argue that economic slumps and financial crises defined the era. Japan, the economic powerhouse of the 1980s, suffered a deep and protracted 10-year recession. Major financial crises in Mexico, East Asia, the Russian Federation, and Argentina retarded the growth of the global economy and deterred investors from venturing into some emerging markets. Terrorism, wars within and between countries, the SARS epidemic, and the scourge of HIV/AIDS eroded consumer confidence and economic growth. The attack on the World Trade Center on September 11, 2001, alone created an estimated loss of about $100 billion. World oil prices have risen steadily since the end of the first Gulf War in 1991, and oil prices skyrocketed to record highs in late 2004, to the detriment of many countries.

There were also strong positive developments in the international economy. In the late 1990s the U.S. economy grew at a high rate and was an “engine of growth” for the world economy. Countries across the globe broadly liberalized trade and investment regulations, allowing more and more entrepreneurs and consumers to benefit.125

The creation of the World Trade Organization in 1995 and the integration of regional trade blocks like NAFTA, Mercosur, and the Eurozone underpinned this movement. Even after averaging out
the highs of the late 1990s with the nadirs accompanying the Argentine financial crises, FDI flows to developing countries more than doubled between 1990 and 2000.

These two economic faces of the last decade reveal much about the current state of the international investment environment. Compared with the earlier, more static eras, the investment environment has become more dynamic and more fluid. Investment opportunities—many in sectors that did not exist 10 years ago—abound in emerging markets throughout the world, but the perceived risks associated with them threaten to thwart many of these opportunities from being seized.

While political volatility, terrorism, and high oil prices continue to plague many of the world’s economies, many financial and economic indicators suggest that the economic slowdown of the past three years has, as of 2004, given way to a broader global recovery. World industrial production measures have returned to their 2000 levels, as have global trade and business confidence indicators. Consumer confidence levels in the industrial world are on the rise, and world GDP growth rates are expected to hover around 4.5 percent during 2004 and 2005, a substantial increase since 2002.

The fruits of the economic upturn, however, have not been distributed evenly among countries. In the developing world, China has remained a star of the global recovery. Increases in investment and exports in China generated annual GDP growth of 9 percent in 2004, with rates of 8 percent forecast for 2005. And contrary to accepted myth, exports are not the only engine of growth in China: consumption is also rising sharply. China is now the world’s third-largest importer of finished goods.

The emerging Asia region has also grown to play a substantial role in the international economy. Growth is expected to be 6.43 percent in 2005, down from 7.0 percent in 2004.

Other developing economies have met with varied success. Although saddled with high levels of unemployment and public debt, Latin American economies are rebounding from the deep recession of 2001–02. Real GDP is estimated to have grown 5.4 percent in 2004 and forecast to be 3.7 percent in 2005. The economies of emerging Europe have demonstrated staying power, growing by an estimated 6.5 percent in 2004. Forecasts expect the region to slow to an estimated 5.8 percent in 2005.126

Energy-dependent economies in the Middle East and Eurasia have also participated in the recovery. Economic growth in the
Russian Federation and the countries of the Commonwealth of Independent States is now estimated at 7.6 percent a year. Although much of this success is related to higher prices in the energy sector, other factors, including increased consumption, wage increases, competitive exchange rates, and investment growth are also contributing to growth. Political instability and violence notwithstanding, countries in the Middle East region are forecast to grow at a respectable 4–5 percent a year in 2005.\(^\text{127}\)

Sub-Saharan African economies have had mixed experiences in participating in the global economic upturn. While there are some positive stories, threats from natural disasters, HIV/AIDS, ethnic and political violence, and economic mismanagement have hurt the growth prospects of many economies in the region. Countries such as Côte d’Ivoire, Ethiopia, and Zimbabwe, all of which had negative economic growth in 2003, face daunting political and economic challenges over the next few years. Nonetheless, real GDP growth in Sub-Saharan Africa should increase to about 4.5 percent in 2005.\(^\text{128}\)

**Foreign Direct Investment: Past, Present, and Future Trends**

FDI to the developed world continued to decline in 2003.\(^\text{129}\) FDI into the OECD area, for example, dropped 28 percent, from $535 billion in 2002 to an estimated $384 billion in 2003. Interestingly, the fall in FDI inflows affected the United States, the country with the strongest recovery in the developed world, the most. Fueled by large repayments of intracompany debt and substantial declines in merger and acquisition activity, inflows of direct investment into the United States fell in 2003 to $40 billion, down from $72 billion in 2002. FDI inflows to European countries were 23 percent lower than in 2002.\(^\text{130}\)

Such dramatic declines in inward FDI flows have not occurred in the developing world. Indeed, 2003 saw the end of the downward trend of FDI to developing countries (figure A.1), and a spate of forecasts (including those by the OECD, the World Bank Group, the Institute for International Finance, and UNCTAD) all expect FDI flows to the developing world to continue to rise in the near term.

In 2003 China surpassed the United States as the world’s foremost recipient of FDI, with inflows totaling more than $53 billion.\(^\text{131}\) With the bulk of this investment supporting the manufacturing sector and new opportunities arising within the services sector, China is poised to attract even more investment in 2005. At the regional
level, emerging Asia has followed China’s lead, receiving more FDI than any other developing region.

The Institute of International Finance estimated in January 2005 that net direct investments to emerging markets should rise from an eight-year low of $91 billion in 2003 to $143 billion in 2005. Emerging Europe, which saw its FDI inflows decline in 2003, rebounded in 2004 and should see FDI increase to $25 billion in 2005, as foreign investors seek to solidify their positions. Many countries in the region are ripe for a second wave of investment activity, as investors look to reap the benefits of the locational advantages of these countries, especially the recent and future EU accession states. Net direct investment in Latin America is likely to remain stagnant around the $35 billion level of 2004, with Mexico and Brazil particularly benefiting. Direct investment in the Asia/Pacific region will continue to be dominated by China, which should account for more than 80 percent of the estimated $75 billion in direct investment expected to flow into the region. India should be the second-largest recipient. Although small in absolute terms, FDI flows to Africa and the Middle East are expected to rise modestly, with South Africa and Egypt particularly benefiting from investment inflows.
Future FDI Trends

Although it is never easy to draw inferences about future FDI flows, three key trends suggest that the uses, sources, and ultimate destination of flows have changed substantially. First, flows to developed countries no longer dominate the international investment landscape. In fact, the shift in emphasis of inward FDI to developing countries is striking. Although it is too recent to be referred to as a confirmed trend, this fact, when considered against the recent global economic upturn and the strong performance of the U.S. economy in particular, is surprising. Moreover, the nature of FDI to developing countries appears to have evolved over the past decade. Previously, it was assumed that multinational corporations invest in emerging markets in order to access resources or to integrate low-wage regions into their global value chains. It is now clear that there is a growing tendency for companies to invest in large developing countries as part of their strategies to service local clients or acquire a strategic position in markets that could become prosperous in the future. (While recent outsourcing enterprises to India seem to suggest a reversion to the older rationale for FDI, outsourcing currently represents a very small percentage of total FDI flows.)

Second, the sectoral distribution of FDI flows is changing. Specifically, FDI to developing countries’ service sectors are increasing rapidly. According to UNCTAD, FDI to the services sector grew more rapidly than any other sector, with the inward stock of services-related FDI quadrupling between 1990 and 2002, from $950 billion to $4 trillion. This substantial increase was led by investments in the telecommunications sector, as global telecom and utility companies took advantage of their rising stock prices and participated in privatization programs in many developing countries. This shift toward services has enhanced the benefits of FDI to developing countries. Foreign-owned service companies are an important source of spillovers to the domestic business sectors, particularly compared with the often limited linkages between extractive industry projects and host economies. The entry of foreign banks, for example, has improved the efficiency of developing countries’ financial sectors, a critical input to their growth.

FDI between developing countries (“South-South” investment) is also burgeoning. UNCTAD statistics suggest that by the end of the 1990s, more than one-third of FDI in developing countries originated from other developing countries. According to these estimates, South-South flows appear to have grown faster than flows from
high-income countries to developing countries in the late 1990s, and they have remained more resilient in the post-Asian crisis period as well. UNCTAD associates the rise in South-South FDI to increased competition or limited growth opportunities in investors’ domestic markets, efficiency-seeking, procurement of raw materials, geographic proximity, ethnic and cultural ties, and other factors. The growing traction of South-South FDI indicates that developing countries are becoming more financially integrated and have access to more sources of investment than ever before. The World Bank estimates that South-South FDI is expected to remain significant for developing countries in the future.¹³⁶

On the whole, most observers expect FDI to increase over the medium term.¹³⁷ And developing countries and transition economies appear to figure more prominently in companies’ investment plans than the large OECD economies. Recent surveys indicate that the regions expected to benefit most from stronger FDI flows are Central and Eastern Europe and Asia. There are also indications that FDI could trend upward over the slightly longer term. Macroeconomic forecasts point to a cyclical recovery in the developed world and enhanced corporate profitability over the next few years.

**FDI Flows and Political Risk Insurance: Understanding the Relationship**

Such shifting trends in the international political and economic climate for investment and FDI flows obviously affect the political risk insurance industry. The total supply of political risk insurance grew rapidly in the 1990s in response to demand and to the significant expansion of global trade and investment. Estimates suggest that roughly $15–$18 billion of new political risk insurance coverage was written in 2003, and the total volume of investment insurance coverage outstanding is estimated to have reached about $80 billion by the end of 2003.

The issuance of political risk investment insurance by members of the Berne Union has increased steadily over the past 13 years (figure A.2).¹³⁸ Given that Berne Union membership in this period encompassed all of the major national investment insurers, the significant multinational insurers, and a steadily increasing number of the significant private insurers, it is a strong surrogate for the entire industry. Indeed, Berne Union members write the majority of political risk insurance coverage issued.
However, if one combines the FDI statistics shown in figure A.1 with the political risk insurance coverage statistics of figure A.2, a different picture emerges (figure A.3). Between 1990 and 2000, a declining portion of new FDI flows to developing countries was insured by Berne Union members (despite a slight but steady increase in Berne Union membership over the same period).

Moreover, between 1992 and 1996—the high-water mark for political risk insurance coverage in the past 20 years—annual FDI inflows to developing countries tripled, from $50 to $150 billion. Political risk
insurance written by Berne Union members more than doubled over the same period, and insurance contracts grew with FDI every year, covering on average of about 10 percent of all direct investments to developing countries.

This healthy growth was short lived. In 1997, despite losses stemming from the Asian financial crisis, global FDI to developing countries continued to grow, while the percentage of those flows covered by political risk insurance fell and then stagnated. For the next four years, the political risk insurance industry retreated from its 1996 high, covering only about 6 percent of all FDI. This was surprising, given that FDI itself was growing rapidly during this period.

By late 2000 this downward trend was correcting itself (figure A.4). While FDI fell in the wake of the Argentine crisis, by 2003 the public and private insurance markets were showing signs of steady improvement, after absorbing the crises and shocks of the previous seven years. Capacity among private insurers seemed to have stabilized, and many major reinsurers were rebuilding their balance sheets. By 2001 political risk insurance was growing relative to FDI flows to the developing world; by 2003, for the first time since 1996, it covered more than 9 percent of these flows. The substantial decline since 2000 in private infrastructure investment contributed significantly to the overall decline in FDI. Of the infrastructure projects that did go forward in 2001–04, however, there was a greater tendency for them to purchase political risk insurance.

Another perspective of this phenomenon is presented in figure A.5, which converts the data on FDI flows and the new coverage issued

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**Figure A.4** Ratio of FDI Covered by Berne Union Investment Insurers to Foreign Direct Investment Flows to Developing Countries, 2000–3

<table>
<thead>
<tr>
<th>Percent</th>
<th>0</th>
<th>2</th>
<th>4</th>
<th>6</th>
<th>8</th>
<th>10</th>
<th>12</th>
</tr>
</thead>
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<td>2000</td>
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<tr>
<td>2001</td>
<td>8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>10</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<td></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

**Percentage of FDI covered by Berne Union members**

**Trend line**
by Berne Union members into an index (1993 = 100). This makes it easier to observe that FDI flows and political risk insurance issued are not in a lock-step relationship. Moreover, coverage issued by any individual investment insurer (such as MIGA) is not necessarily related to either macro-statistic.

Hence to revert to the imagery of the introductory paragraph of this paper, there is no convincing evidence that either the general flow of FDI or the specific flow of FDI to emerging markets has had a determinative impact on the annual volume of political risk investment insurance issued. Many complex forces are at work shaping the trajectory of the industry. These forces, which relate to the underlying structure and character of the political risk insurance industry, are discussed in the next section.

The Contours and Character of the Political Risk Insurance Market Supply-Side Forces

Public Sector

Political risk insurance was first proposed following World War II as a means of encouraging private American investors to help rebuild war-torn Western Europe. At the time, Europe was seen as politically unstable, a volatile region prone to periodic regional warfare.
Moreover, perceived threats from a possible Soviet invasion or a major currency devaluation caused U.S. firms to initially balk at investing in the region.

Interestingly enough, it was the U.S. government, not private insurance companies, that eventually offered political risk insurance as a solution to the problem of noncommercial risks inhibiting private investment in Europe. The Marshall Plan included legislation providing for U.S. government insurance to U.S. investors against the risks of currency inconvertibility, expropriation, and political violence.140

The public sector origin of political risk insurance should not come as a surprise. Insuring private investments abroad from violence and sovereign malfeasance was very different from insuring against any other risk known to the market at the time. First, actuarial science and statistical modeling could not accurately inform political risk insurance underwriting decisions. Second, unlike many other risks, political threats could be thwarted—and even eliminated on occasion—by a third party with enough influence to persuade key parties to change their possible behavior. Third, extremely large levels of capital resources were required. Finally, only the public sector had the resources, knowledge, and influence needed in the 1950s and 1960s to provide credible and prudent coverage to the private investors.

Out of this early experience, public sector insurers developed an image of themselves as bold underwriters. With a strong capability to bear risk, public insurers became the foundation of the political risk insurance industry, providing an element of constancy in a business rife with risk and uncertainty.

However, the reality was that as instruments of national (or multinational) policy, public providers’ respective legislative mandates and eligibility criteria shaped which investments they could support. For example, because of U.S. policy, OPIC has not written any coverage in China since 1989, even though China has been the largest recipient of FDI in the developing world for the past seven years and—as of 2003—received more FDI flows than any other country in the world.

MIGA, in contrast, can cover deals in China, but it cannot issue insurance for investments in Mexico or by Mexican investors, because Mexico is not a MIGA member state as of 2004. Moreover, MIGA’s mission to promote productive FDI to its member developing countries both guides and restricts its operations. Like the foreign policy aims of individual OECD countries’ national investment
insurance programs, MIGA’s development agenda puts additional pressure on it to provide coverage to investors venturing into the poorest developing countries, even when the bulk of FDI flows are not going there.

Other external factors also affect the public insurers’ capacity and underwriting decisions. First, public sector providers receive their capital from government coffers, which are independent of market forces. This fact enables some national programs to write as much political risk insurance as their governments request. Other national programs, such as OPIC, have very high total capacity ceilings. MIGA’s capital, with the approval of its Council of Governors, has grown significantly since 1999 (figure A.6). This infusion of liquidity has enabled MIGA to substantially grow its capital, irrespective of market conditions. The agency’s risk-bearing capacity (as measured by the ratio of operating capital to net exposure) was enhanced by more than 66 percent between 1999 and 2004.

Second, reaction to political stimuli and changes in national leadership frequently refocus the basis on which public providers determine if they will support projects and how they go about doing so. The build-up to, and fallout from, political conflict or the strengthening of relations between states can significantly affect the geographic and sectoral focus of a public insurer’s underwriting decisions. This phenomenon can be seen in OPIC’s recent activity, in which fully a quarter of its underwriting in 2003 was committed to investment projects in the Middle East.\footnote{141}
Thus while there is a veneer of stability on the surface of public insurer activity, in reality the policies that govern their underwriting decisions are subject to change. Exogenous factors and requirements, which bear no relation to demand or to market forces driving business decisions for other lines of insurance, continue to substantially shape the supply of public sector political risk insurance to investors. Since the public sector represents 40–60 percent of the market, these external forces constitute a significant influence on the marketplace as a whole. Moreover, when one or more major public insurers decides that the risks in a particular country are unacceptable, it casts a shadow over any private insurers’ willingness to write new political risk insurance coverage.

Private Sector

Public sector agencies constituted the bulk of political risk insurance supply and product innovation until the late 1970s, when private sector insurers such as Lloyd’s and AIG joined the political risk insurance market (table A.1). While the private sector firms’ appetite for individual project exposure was limited and their tenors significantly shorter (one to three years) than those of their public sector counterparts, private providers developed a business model that satisfied aspects of investor demand left unfulfilled by the public sector. Due to their freedom from eligibility and policy restrictions,

<table>
<thead>
<tr>
<th>Provider</th>
<th>Year Created</th>
<th>Public</th>
<th>Private</th>
</tr>
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<td>OPIC and predecessors (U.S.)</td>
<td>1951</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>BMWA/PwC (Germany)</td>
<td>1960</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>EDC (Canada)</td>
<td>1969</td>
<td></td>
<td>X</td>
</tr>
<tr>
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<td>1972</td>
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<td>X</td>
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<tr>
<td>SACE (Italy)</td>
<td>1977</td>
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<td></td>
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<td>1981</td>
<td>X</td>
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<tr>
<td>AIG</td>
<td>1982</td>
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<tr>
<td>COFACE/UNISTRAT (France)</td>
<td>1987</td>
<td></td>
<td>X</td>
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<tr>
<td>MIGA</td>
<td>1988</td>
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<td>Sovereign</td>
<td>1997</td>
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<tr>
<td>Zurich</td>
<td>1997</td>
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*Source: Public sector annual reports; private sector insurer fact sheets.*
private firms could offer competitive premium rates, flexible coverage, and swift issuance to clients. Consequently, the growth of private insurers burgeoned during the 1990s. New companies, such as Sovereign and Zurich Emerging Markets, were formed to meet demand; capacities increased and tenors lengthened.

External forces also affect the supply of private political risk insurance capacity and influence activity in the marketplace. While private firms are not constrained by public policy objectives and eligibility criteria, the availability of capacity is directly influenced by the profit and loss potential posed by different lines of insurance and the availability, conditions, and cost of reinsurance.

For private sector providers, the general health of the insurance industry and the position in the insurance and reinsurance cycles are of crucial importance. The availability of capital resources for political risk insurance coverage can be affected by losses in other lines of business and can force managers to withdraw capacity in order to seek more profitable or safer returns elsewhere. For smaller political risk insurance firms, losses in “removed” lines of insurance (such as property losses stemming from a hurricane) might not affect their immediate operating capital, but they will affect their ability to acquire reinsurance. In either scenario, the supply of private political risk insurance is directly related to exogenous shocks that ripple through the entire insurance industry. After September 11 and the Argentine crises, irrespective of concerns related to terrorism and currency melt-down, the availability of capital curtailed political risk insurance capacity simply because the significant losses elsewhere consumed capital throughout the insurance industry. Some reinsurers exited the political risk insurance market; others curtailed capacity through tighter project and country limits.

While public and private sector investment insurers operated largely independent of each other in the 1970s and 1980s, frictions arose when private sector providers increased their tenors substantially in the 1990s. The perception of competition grew, and arguments and insinuations that the public insurers were “crowding out” private insurers were heard from both private sector participants and observers. In fact, since their underlying business models and objectives were so different, there was little direct competition, except on an occasional project. The mere existence of other insurers did not change what made each sector appealing to its investor clients. Consequently, each side pursued a de facto policy of accommodating the other’s existence. Such a policy allowed each party to cooperate and collaborate on some investment projects and operate
independently for others. After 2001 many private insurers had no choice but to shorten their tenors and the amount of coverage they could write per risk. Since they could not serve clients as they previously had been able to do, possible coinsurance and reinsurance deals with the public sector became more attractive for many reasons, including the perception of lower risk.

There seems to be a great deal of anecdotal evidence in the post-2001 environment of a “natural siphoning” phenomenon between public and private providers of investment insurance. When private capacity is available on comparable (or better) terms and conditions, clients flow naturally to private insurers, which generally have the advantage of speed and flexibility. When the risks are considered exotic, the projects are located in an area of active conflict, the investment is particularly large or salient in a poor country, or the project crosses international boundaries (e.g., pipelines), the flow of business naturally gravitates toward public or multilateral providers. When a public insurer reorients its programs, as OPIC did in 2003, toward smaller investors and projects with significant developmental effects, nonqualified investors are “pushed” toward private insurers. Likewise, when public providers withdraw for policy reasons from certain types of investments (e.g., casinos, alcoholic beverages, military-related projects), private insurers have an opportunity to provide coverage.

In sum, there is considerable elasticity on the supply side of political risk insurance. Many national and multinational entities have the capacity to write much higher levels of coverage under their existing authorities than they currently do, and many have the capability of extending their issued coverage to even higher levels within a year or two. Private insurers can expand their issuance of political risk insurance coverage in an even shorter time frame. Hence there are very few hard limits on the ability of investment insurers to issue substantially more coverage than they have.

The Contours and Character of the Political Risk Insurance Market: Demand-Side Forces

As the statistics previously noted in this paper reflect, political risk insurance is not purchased for the majority of FDI in developing countries. The users of political risk insurance are heterogeneous and seek coverage for different reasons. It is difficult to characterize why some investors seek coverage while others choose to bear the
risk of loss, or to transfer some of the effects of a loss to others. However, some types of demand can be identified.

Some investors buy political risk insurance as a defensive response to broad country-level or regional events, even if no specific threat from a host country to a transaction or project appears imminent. For these investors, recent negative events—not business analysis—drive their purchasing decision. The Asian and Latin American crises offer a case in point. In the months and years following the two crises—at precisely the moment when FDI flows to Asia and Latin America were plummeting—demand for political risk insurance in the regions began to swell. This postcrisis impact on political risk insurance issuance can vary greatly depending on the nature, extent, and pervasiveness of the crisis. For such investors, recent crises in a region remind them of the very real risks they may face in making investments in the region.

The purchase of political risk insurance in project finance situations was often attractive to both debt and equity investors because it allowed them to better price and allocate the political risk among themselves. With the fall-off in limited recourse financings in the past four years, demand for political risk insurance from this source has declined dramatically. However, any substantial new wave of privatizations and project financings of major infrastructure or extractive industry projects will likely stimulate this source of demand for political risk insurance coverage.

Other sophisticated investors have concerns only about the political risks associated with a few specific investment exposures, for which they seek coverage. These investors’ risk management decisions are often unique, one-off decisions that are driven by the economic and political conditions associated with a particular investment exposure rather than by broad regional or international phenomena.

For still other investors, many of them smaller firms, their scarce human resources attract them to a national insurer for political risk insurance coverage, or they leave the task of finding appropriate coverage to a broker. Entrepreneurs and smaller firms from developing countries face a particular challenge, because their countries may not have a public political risk insurance program for them to utilize and they are not well served by the private brokerage community to access private coverage. These investors may discover that multilateral entities such as MIGA or the Inter-Arab Investment Guarantee Agency exist and can offer coverage, but often they simply proceed without coverage or abandon the proposed venture.
The heterogeneity of the prospective users of investment insurance makes it difficult to estimate both the current and prospective future demand for coverage. Moreover, other phenomena affect the risk management decisions of firms. Numerous indications suggest that the international investment climate in many developing countries has improved in the past five years. Better information about operating conditions and improved laws and regulations make investors more comfortable and less uncertain about the protection of their assets and property rights.\textsuperscript{146}

New bilateral investment treaties and double taxation agreements with developing countries positively affect investor risk perceptions. The number of bilateral investment treaties signed annually in the developing world more than quadrupled over the past 13 years, and the number of double taxation treaties doubled (figure A.7).

At the local economy level, countries have done much to improve their business climates, thereby making their economies more attractive to international investors. Specifically, they have improved their treatment of the private sector, due in part to aggressive local policies and reforms suggested by international financial institutions. Indeed, emerging market economies are increasingly focusing on improving the local business environment. Since 1990 legislatures in developing countries have more than tripled the number of domestic regulations enacted that are considered favorable for attracting foreign investors.\textsuperscript{147}

\textbf{Figure A.7 Number of New Bilateral Investment and Double Taxation Treaties Signed in Developing Countries, 1990–2003}

While regulatory reform has made progress worldwide, some regions have made greater strides than others. In 2004 most regions of the world—except Asia—reduced the red tape that had made it difficult to start up business operations in developing countries. In the Middle East, Eastern Europe and Eurasia, and Africa, weeks have been cut from the process (figure A.8).

Since investors make their risk management decisions based in part on perceived local conditions, it is not surprising that interest in political risk coverage wanes where the investment climate is substantially improving. As host countries continue to improve business transparency and reduce the costs associated with interacting with the host government, investors will be less inclined to purchase political risk coverage.

Finally, one of the primary users of political risk insurance are banks, which need to provision their cross-border exposures while simultaneously reducing capital allocation costs. Banks do not buy political risk insurance for every international exposure; their purchases are based on their own internal risk management concerns in conjunction with decisions about meeting their own and national regulatory requirements. Like equity investors, banks turn to political risk insurance as a source of reassurance and security. But they also must satisfy their Basel II requirements concerning capital allocation. Since commercial banks often represent a large proportion of the debt financing used in large extractive and infrastructure

**Figure A.8 Average Number of Days Needed to Start a Business, by Region, 2003 and 2004**

![Graph showing average number of days needed to start a business by region, 2003 and 2004.]

projects, demand for political risk insurance coverage can be substantially driven by their aversion to risk.

Basel II addresses the situation in which lenders have protection under the B-loan programs of multilateral development banks or through guarantees and insurance provided by those multilateral development banks against transfer and convertibility risk. If the lender has such protection and the multilateral development banks meet certain criteria, national regulatory authorities may consider that the sovereign risk has been mitigated and consequently that provisioning costs can be reduced. This should stimulate lender interest in obtaining coverage from institutions such as MIGA. It could also stimulate renewed interest in limited recourse project financings of large infrastructure and extractive industry projects.

Seeking a Balance

In the analysis above, we have argued that both the supply and demand for political risk insurance is the result of a complex calculus of forces. Demand for political risk insurance—while linked in some fashion to international investment trends—is not determined simply by FDI flows. Instead, multiple forces shape the trajectory of political risk insurance demand. At the same time, multiple factors affect the supply side, where available capacity is merely one element influencing which investments can and will be insured. Thus the market is affected both by endogenous forces that shape supply and demand and exogenous forces that originate in the larger international politico-economic milieu. The interplay of both exogenous and endogenous forces makes the political risk insurance market highly susceptible to change, making its future evolution more difficult to assess.

The recent investment boom in China illustrates the complex interplay between the various forces at work in the industry. Although governmental policy in the 1980s and early 1990s created a dramatic increase in FDI to the country, political risk insurance business continued to lag. Indeed, recent research suggests that demand for political risk insurance in China is lower than demand in Indonesia and the Philippines combined. When FDI flows to these countries are viewed in relation to those of China, it becomes apparent that the linkage between FDI flows and political risk insurance issuance is weak (figure A.9).
The key to understanding the relationship between FDI and political risk insurance is to resist using the logic that a rising tide lifts all ships but instead to consider the influence of all the demand forces shaping the political risk insurance market for China. Indeed, as more international investment flowed to China and the investment climate improved, additional investment opportunities arose. At the same time, investors perceived that doing business in China was substantially less risky than doing business in other countries in the region.\textsuperscript{149}

Other anomalies in the market further shape supply and demand trends for political risk insurance in China. Political decisions have prohibited OPIC from writing any coverage in China since 1989, even though over the same period U.S. investments represented roughly 7–10 percent of all FDI to the country.\textsuperscript{150} OPIC’s inability to write business in China has likely pushed some U.S. investors to private insurers or to MIGA, which has been active in covering U.S. investment in China. While some observers believe that demand for political risk insurance in China has recently increased, the relative political calm and economic prosperity suggest that the forces shaping the political risk insurance market for China are fundamentally stable and that the overall demand and supply trend for the country will also remain stable.
Conclusions

Like all insurance markets, the investment insurance market will be subject to many forces, both macro and micro, that will influence its future evolution. While it is difficult to identify all the factors that may have some bearing, it is even more difficult to consider their interactions and to net them out to understand the magnitude and direction of the market. In broad terms, the future seems bounded by the two parameters of growth versus stagnation. From the perspective of early 2005, it seems unlikely that decline is possible. The storms and crises of 1999–2003 have served to reequilibrate the industry at a lower volume level, but the key providers have survived and are clearly committed to staying in the business. Public-private insurer collaboration has increased markedly in this period, to the benefit of both groups of insurers but even more important to the benefit of investor clients. Significant losses to investors have occurred, and those with investment insurance have benefited from either the payment of claims or the minimization of the loss. Many near claims have been averted or deterred. Awareness of political risk loss possibilities is high among investors. More brokers are knowledgeable about political risk coverages and more adroit in briefing clients about the benefits of coverage from different insurers. The major national and multinational entities offering coverage have strong balance sheets. Hence a decline in the political risk investment insurance industry seems unlikely.

However, in discerning the possible paths between stagnation and growth, the prognosis is more difficult. Notwithstanding the 50-year history of these political risk coverages, there is a certain fragility to the market. Some of that fragility stems from the small size of the industry relative to the immense size of the property, casualty, or life insurance markets. All small lines of specialty insurance, be they satellite launch, event cancellation, or political risk investment insurance coverage, are vulnerable to buffeting by the reinsurance market cycle. The vulnerability of reinsurers to major natural catastrophe losses is well known.\footnote{151}

In addition to exogenous forces that could affect the political risk insurance industry, internal forces could contribute to stagnation in the industry. First, the industry has underinvested in new product development. Some of this stems from the relatively small number of skilled underwriters available to develop such coverages. Moreover, it takes several years to develop, secure management approval for, and “debug” specialized breach of contract coverages
for infrastructure projects before they can be widely offered in the market. The specialized coverages needed for investments in certain industries (e.g., oil and gas exploration and development) can take years to develop—and then may not win market acceptance. Private insurers have difficulty making the staff investment to research and develop such coverages; they are much better at swiftly adapting and perfecting a coverage initially developed by a public entity. Unless substantial and sustained investment in new product development and innovation occurs, stagnation becomes more likely.

Second, within some private insurers, the departure of several key staff members would likely end the firm’s underwriting of this line of business. Without a commitment to training younger staff or a program of regular replenishment by raiding staff from public insurers, the commitment to offering these coverages is vulnerable to quick cancellation. Likewise, several large net losses could endanger the continuation of political risk insurance underwriting by some of the smaller insurers.

Third, while public providers may be insulated from some of the capital cost considerations that affect their private sector counterparts, they are subject to periodic policy upheavals as new political leadership decides to alter eligibility criteria, alter the regional or sectoral focus of their business plans, or exit certain types of business for risk management reasons. As a result, year to year fluctuations of 100 percent or more in the volume of political risk coverages are not unknown for public insurers. The lack of continuity in offerings confuses prospective investors.

Finally, new national and multilateral entrants offering political risk insurance or financial risk guarantees (that in some ways supplant classical political risk coverages) make it more difficult for existing insurers to build a balanced portfolio that makes optimal use of their capital. For new entrants, building up a balanced portfolio is exceptionally difficult.

All of these forces could contribute to ossification in the industry. There are, however, forces that could stimulate steady growth, innovation, and improvement in the industry. First, globalization is both pushing and pulling OECD investors toward emerging markets. The flow of new FDI is expected to remain stable or rise slightly during the next few years. Second, many firms are first-time investors in the developing world. They are understandably nervous about their initial forays into these markets and are thus predisposed to considering investment insurance. Third, for some multilateral insurers, such as MIGA, the small but growing trend of South-South investment
will create business opportunities, as will transborder investments such as pipelines. Fourth, prices for many mineral commodities are high, and the substantial up-front capital investments associated with developing new mines or significantly expanding existing mines make them prime candidates for investment insurance coverage. Fifth, pervasive problems associated with recent infrastructure projects in the energy and water sectors make new projects in these sectors attractive candidates for coverage.

The prospect of major political shocks to the whole international system is, of course, unknown. Events such as September 11 are inherently impossible to forecast. However, less severe political upheavals can be expected as part of the “normal” level of chaos associated with leadership challenges or changes in emerging market countries. Such events stimulate general investor awareness of the need to manage political risk. There are high expectations that such stimuli will continue to occur regularly over the next few years.

Finally, the ability of some investment insurers to offer effective “after-care” services to help investors resolve investment disputes with host governments through informal or formal mediation efforts or to insulate investors from arbitrary or discriminatory actions by host governments means that investors can avoid some political risks. This side benefit to investors becomes an important consideration for a risk management decision that an investor must make for the next new project investment.

Investors have options for managing these political risks, of which insurance is only one. Political risk insurance is not a product that essentially sells itself; it must be sold by knowledgeable underwriters and brokers who customize the coverage to fit the particular needs of an investor. Political risk insurance can be actively sold as a flexible instrument, adaptable to meet the risk management needs of equity and debt investors; insurers that wait for clients to knock on their door will miss potential opportunities. Insofar as there are many first-time investors or once a decade purchasers of such coverage, the need for industry members to both educate new investors and actively market their product is high. Indeed, it may be determinative of the overall robustness of the political risk insurance market.

Notes

127. Ibid.
128. Ibid.
130. Ibid.
132. Institute of International Finance, op. cit.
137. A recent survey of investor intentions released by UNCTAD in its World Investment Report 2004 found that more than 70 percent of the largest multinational enterprises expect FDI to increase over the next three years.
138. The Berne Union is an organization comprising 52 members from the export credit and investment insurance industries from more than 40 states. The Union works for international acceptance of sound principles of export credit insurance and foreign investment insurance. It also provides a vital forum for the exchange of information, experience, and expertise between members.
139. Even if one “corrects” the Berne Union issuance statistics by excluding the activities of the private sector members (AIG, Sovereign, and Zurich), the ratio of FDI covered by political risk insurance remains flat between 1997 and 2000.


149. Ibid.

150. Authors’ calculations based on investment information in the OECD’s Direct Investment Database and UNCTAD’s 2003 *World Investment Report*.

151. Tobin, op cit.
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