The place of Political Risk Insurance in the political risk management strategy of multinational corporations

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Confronted with a variety of political risks that affect their international activities, multinational corporations (MNCs) can use Political Risk Insurance (PRI) as a method to mitigate some of those risks. The aim of this article is to present the main characteristics of the PRI policies and participants, to highlight its benefits and to put forward three limitations that prevent MNCs in using PRI in their political risk management strategy (fluctuating capacity on the market, high premium rates and small compensation value). The recent trend in incorporating corporate social responsibility requirements as a pre-condition for providing PRI can contribute to lowering PRI premium rates.

Keywords: political risk insurance, risk management, multinational corporations
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1. Introduction

PRI is a relatively recent activity whose origins go back to the Marshall Plan in 1948. It came into the spotlight after the terrorist attacks of 11 September 2001. The events in the past years, like the Arab Spring and the more recent conflicts in Ukraine, Russia and Syria have further brought PRI to the attention of MNCs and experts.

Wagner (2012) defines PRI as a special category of insurance that protects traders, investors and creditors against political risks that occur while performing business contracts, own or make use of investments or pay interests related to an investment loan. For the purpose of this article and in the PRI context, political risks are defined as "arbitrary or discriminatory actions, taken by home or host governments, political groups, or individuals, that have an adverse impact on international trade or investment transactions" (Wagner, 2012: 97).

2. Market participant and characteristics of PRI

According to a report of the Multilateral Investment Guarantee Agency (MIGA), the PRI market includes three broad categories of providers (MIGA, 2011): public and private PRI providers, and reinsurers. Public PRI providers can be either national export credit agencies (ECAs) or multilaterals like MIGA, the African Trade Insurance Agency, the Asian Development Bank, the Inter-American Development Bank, the Inter-Arab Investment Guarantee Corporation and the Islamic Corporation for the Insurance of Investment and Export Credit. MIGA is the largest of the multilateral programs and was founded in 1988 as a member of the World Bank Group. Public PRI providers benefit from the support of the respective states or of multilateral organisations like the World Bank. They are not profit oriented and their activity is constrained by the governments' foreign policy and international development and sustainability goals. As for private PRI providers, the majority are

based in three insurance centres: London (Lloyd's syndicates), Bermuda, and the United States. Contrary to public PRI providers, they are profit oriented insurance companies. It is due to this attribute that public and private PRI insurers offer distinctive terms for their PRI policies. The main differences are summarised in Table 1.

Table 1

	Public insurers	**Private insurers**
Tenor	**Long term**: Longer-term investments, up to 20 years.	**Short to medium term**: Usually from three to five years because of reinsurance constraints (Wagner, 2012); recently some private insurers have started to offer insurance policies of up to 15 years, e.g. AIG, Aspen, Chubb, Fidelis, Liberty Mutual Insurance Europe, Sovereign, XL Catlin and Zurich (Gallagher, 2016).
Flexibility	**Less flexible**: They have to take into account foreign policy considerations. For instance, the Overseas Private Investment Corporation (OPIC) is constrained by broader US foreign policy objectives (Bremmer and Keat, 2009); Multilateral PRI providers have to make sure that the insured projects comply with broad development and sustainability goals.	**Very flexible**: Private insurers accommodate more easily to the companies' risk profile, offering more tailored made policies.
Level of premium rates	**Rather constant**: Relative narrow range.	**High fluctuation**: Can vary widely based on supply and demand and tend to be

	Public insurers	**Private insurers**
		higher than the premium rates offered by public PRI providers (Tan, 2015).
Application process response time	**Lengthy:** Close to a year or more (Teach, 2014).	**Very short:** 45 to 60 days.
Other	They have government connections that can help settle disputes before the PRI is triggered; Can offer higher capacity (MIGA, 2011).	They cover a wider array of risks (McKellar, 2010); the recent trend is the provision of multi-country insurance policies (15 to 20 countries) which allow underwriters to spread their political risks across several countries (Marsh, 2014). They are unable to provide currency transfer and political violence coverage in many developing countries and emerging economies (West, 2008).

As regards reinsurers, some of the top companies include Munich Re and Hannover Re (Germany), Swiss Re (Switzerland), and Berkshire Hathaway/General Re (United States). Export credit agencies and multilaterals also offer PRI reinsurance, although on a smaller scale. Reinsurance is an important activity driving both pricing and capacity in the private market.

PRI providers typically cover losses coming from four broad types of political risk (Jakobsen, 2012): political violence (war, terrorism and civil disturbance); expropriation; currency inconvertibility and transfer restrictions; breach of contract/arbitration award default. MIGA adds to this list the risk of non-honouring of sovereign financial obligations

(MIGA, 2011). In order to be compensated using PRI, MNCs have to prove the political nature of those losses (Solimene, 2014).

3. Benefits of PRI

PRI is not only useful as a compensation tool for potential losses, but also for its impact. First, it can help investors access finance and, in some cases, on better terms, increasing the tenors and size of available loans (Bremmer and Keat, 2009). Investors are often required to obtain PRI insurance in order to obtain financing from banks. Second, for lenders, PRI can provide regulatory relief from country-risk provisioning requirements (e.g. Basel III regulations). Finally, when provided by multilateral and large national insurers, PRI can also help deter harmful actions by host governments, help resolve investment disputes, and provide access to best practices in environmental and social standards (so called "deterrence role"). In this case, PRI becomes a guarantee that the host government will meet its obligations. Jakobsen (2012) and West (2008) underline that PRI providers play also a role of mediators in case of disputes between the host government and the MNC. Howell (2008) argues that a government might be less likely to expropriate assets of a firm that bought insurance from OPIC or MIGA. The deterrent role of MIGA is reflected in the very few number of cases when MIGA had to pay claims, only eight claims since its inception in 1988.

4. Limitations

The role of PRI in promoting foreign direct investments has always been recognised by both investors and governments. However, recent studies show that MNCs are still not using PRI in their political risk management strategies. In its research that included 49 German companies operating in Saudi Arabia, Hain (2011) finds that only 8% of the respondents purchased commercial political risk insurance to transfer parts of their political risk exposure. According to the MIGA-EIU Political Risk Survey 2013, only 15% of multinational enterprises

were using political risk insurance as a tool to mitigate political risk in developing countries (MIGA, 2013). According to the political risk survey published by StrategicRISK on 1 September 2015, only 20% of Asia-Pacific firms have a political risk insurance policy, despite political risk being a top 10 risk for 80% of respondents. Kesternich and Schnitzer (2010) observe that most of investors are not aware of this instrument or if they are aware of it, they are not using it. PRI awareness has increased in recent years, but secrecy and lack of information may keep PRI outside the investors' horizon. While the participation of public insurers in a project is known, professional practice in the private sector requires that a PRI policy is kept secret (West, 2008; Jakobsen, 2012). The private insurer has a sound legal basis for rejecting the payment of a claim in case the existence of the PRI policy is revealed and the claim occurs. West (2008) notes that this secrecy is also reflected in the academia and media, where information on the PRI policies concluded is scarce.

For the MNCs that are aware of PRI, the article puts forward three constraints that reduce the take up of PRI policies: fluctuating capacity on the market, high premium rates and small compensation value.

4.1 Fluctuating capacity on the market

Recent years have seen an important increase both in terms of supply and demand for PRI. In 2015, the private PRI capacity of the market reached 2.4 billion USD for a single policy (almost double the available market capacity in 2009 (StrategicRISK, 2015:12). While the public PRI market is more stable, private PRI market capacity varies widely. PRI supply on a market stops almost immediately in case that market is affected by high scale conflict and violence. As the PRI insurance broker, Willis, highlighted in its report on market place realities for 2016, "the time to look into political risks cover is before open conflict arises and the markets withdraw coverage options" (Willis, 2015: 24). For instance, insurers stopped underwriting PRI

policies in Ukraine and Russia following the political unrests in 2014 (Marsh, 2014). PRI availability is also limited for conflict-affected or fragile states (Wille, 2016). In the case of Repsol, the Spanish MNC nationalised by the Argentinean government on 16 April 2012, apart from the underwriters' unwillingness to insure a high risk country like Argentina, a brief analysis of the market capacity at that time showed that no private or public PRI provider could have offered a PRI coverage to compensate for its expropriation (Iftinchi and Hurduzeu, 2013).

4.2 High premium rates

In the last several years, the PRI market has developed significantly. The increase in the number of participants brought new products on the market, longer tenors and higher coverage. All these improvements, combined with favourable market conditions, caused a decrease in premium rates, making PRI more affordable for MNCs (StrategicRISK, 2015). However, there are at least two reasons that support the MNCs' perception that PRI premium rates are still too high. First, because of the particular characteristics of political risk, PRI policies differ from the typical insurance products. Very often, political risk does not fulfil the conditions to be qualified as an insurable risk. For instance, the insurer may not be able to determine statistically the probability of an event generator of political risk or to make sure that the value of the damages does not exceed its insurance capacity (Gordon, 2008). Thus, calculating PRI premium rates goes beyond the usual actuarial tables of risk used for usual insurance policies involving a more subjective and comprehensive assessment, with a high degree of customisation (Webb, 2012). This complex activity of transforming uninsurable risks in insurable ones (Baublyte, Mullins and Garvey, 2012) makes PRI more expensive than the usual insurance products. Second, PRI premium rates, especially from private reinsurers, are higher in risky countries and can increase immediately when political unrest is escalating. In the past, MNCs

complained that market offered acceptable priced insurance only for countries where political risk was insignificant (Hood and Nawaz, 2004), thus leaving investors without insurance in places where risk was high (and the opportunities for making profit were also high). The deterioration of the political environment triggers an increase in premium rates, like it happened in Ukraine and Russia following the political unrests in 2014 (Marsh, 2014). When PRI is too expensive in comparison with the profits stemming from the investment for which the insurance is sought, a MNC can only conclude by abandoning the idea of getting PRI and focus on other methods to mitigate its political risks.

4.3 Small compensation value

The amount of compensation paid to investors following a PRI claim is small compared to the real value of their investment for two reasons. First, PRI policy does not ensure the full recovery of losses. Political risk policy involves a deductible, for instance 10% which can translate into important losses in case of a significant event. Second, the amount of compensation usually does not cover the real value of an investment. As a rule, political risk insurers do not offer fair market value compensation without capping that amount to the book value. Fair market value compensation and, in particular, compensation based on forward-looking calculations (like discounted cash flow methods or capitalisation of earnings) may be offered only in exceptional circumstances (Gomezperalta and Johnston, 2011).

5. Conclusions and directions for future research

Despite its benefits and recognised role in mitigating political risks, MNCs are still not using PRI in their political risk management strategy. The fluctuating capacity on the market, high premium rates and small compensation value are three limitations that can explain the reduced take up of PRI. The good news is that recent market research shows that when not using PRI, MNCs are using other instruments to

mitigate political risks (like engagement with the local government, non-governmental organisations and host communities, creation of joint ventures etc.). PRI has significant limitations, but in particular circumstances, it can prove invaluable (Bremmer and Keat, 2009). It is true that using solely PRI to mitigate political risks is not sufficient (Ting, 1988; Jensen, 2005; Jakobsen,2012), but MNCs should include PRI into their broader risk management strategy (MIGA, 2011). A recent trend in PRI policies is the inclusion of corporate social responsibility (CSR) measures as a condition to access PRI both from private underwriters or international organisations like MIGA (Rosenau et al., 2009). Engagement with host communities can reduce the probability of a pay-out (Webb, 2012; Waters, 2015). Future research should focus on the way to translate the CSR contribution to the decrease of political risk into a decline of PRI premium rates.

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Keywords: Political Risk, Multinational Corporations, Management Strategies, Host Government, Joint ventures. 1. Introduction The political environment can be a very strong factor in nurturing economic growth or a country and Zimbabwe is not an exception in as far as such a notion is concerned.Â Ultimately, the exact definition of "political risk" will be listed in any insurance or guarantee documentation. Political risk results from changes to the political and socio-economic conditions of the host country from those that existed at the time the agreements in question were originally entered into (Berlin 2004).Â They noted that complexity in the political risk equation exists because varying corporate entry strategies and industries cause different political risk exposures.