A study of political risk selection and pricing among private insurance providers: A mixed methods approach

By

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A thesis submitted in fulfilment of requirements for the degree of Doctor of Philosophy

Kemmy Business School
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2012
DECLARATION

I hereby declare that this thesis is entirely my own work, except where otherwise acknowledged. It has not been submitted as an exercise for a degree at any other university or institution.

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Signed: __________________________
Lijana Baublyte

Dated: 25th October 2012
For my parents Milda and Gediminas Baubliai

And in memory of my grandfather Petras Tamukėnas (1919 -2009)
ACKNOWLEDGEMENTS

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A number of individuals played a crucial role in my data collection efforts. While they and their companies wish to remain anonymous, I would like express my deepest thanks to all those who participated and helped me in this study.

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October 2012
ABSTRACT


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This study demonstrates that the basis of decision-making and risk-pricing in the UK Political Risk Insurance (PRI) market is a combination of Art and Science, with factors such as trust and reputation playing an important role. The study breaks new ground by conceptualising and examining different methods and strategies of political risk underwriting employed in the UK private insurance market which do not rely on statistical tools as seen in more traditional insurance types. The PRI sector has been largely overlooked by regulators and academics alike, despite the fact that the market helps to promote foreign trade and contribute to the economic development of emerging markets (see e.g., Gordon, 2008; Jensen, 2008; Hollywood, 1992). Moreover, it is a profitable industry that generates around US$1 billion in premiums annually (MIGA, 2010).

PRI is a challenging research field for a number of reasons. Firstly, it is a highly specialised niche market with the total of 82 public and private PRI providers worldwide, of which 49 are the members of Berne Union (Berne Union, 2010). The market can be further sub-divided into three even smaller distinct markets such as multinational providers (e.g., MIGA), national providers (e.g., OPIC, ECGD or ONDD) and private PRI providers (e.g., Chubb, ACE, or Zurich). Secondly, it is a relatively new line of business, the origins of which can be traced back to the Marshall Plan in 1948, with the private PRI market being formed in early 1970s (DeLeonardo, 2005). Finally, the sector suffers from lack of transparency with very little data publicly available (Spagnoletti and O’Callaghan, 2011).

This study overcomes obstacles of shortage of data by adopting an innovative research design which has enabled the generation of primary qualitative and quantitative data. It is a semi-experimental study that combines grounded theory analysis (Glaser and Strauss, 1967) and scenario-based survey approaches. The semi-experimental study approach was chosen as it allowed to control for more context-specific variables that could impact on an underwriter’s risk perception and risk acceptance. A total of 104 participants successfully completed the survey. It is the first study to apply this approach to the field of PRI underwriting.
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A study of political risk selection and pricing among private insurance providers: A mixed methods approach
CHAPTER 1: Introduction

1.1 Introduction

This study is devoted to an analysis of political risk underwriting and decision-making process in the UK Political Risk insurance (PRI) market, an area which has been largely overlooked by regulators and academics alike (Spagnoletti and O’Callaghan, 2011). It breaks new ground by conceptualizing and examining different underwriting methods and strategies employed in the private insurance market. As will be seen later in this study, the UK PRI market does not rely on statistical tools, as in more traditional insurance sectors. Instead, what we find in the PRI business is a privileging of experience and intuitive knowledge over actuarial protocols.

PRI is a relatively new line of business in the private insurance market. The origins of the contemporary market can be traced back to the Marshall Plan in 1948, under which the US government offered to provide coverage against certain political risks for its investors investing into post-war Europe (Zakariya, 1986). However, the private market expansion did not start until 1971, the year when Lloyd’s signed a reinsurance agreement with Overseas Private Investment Corporation (OPIC). With three lead insurance syndicates providing coverage for nationalization, confiscation and expropriation perils in 1973, The Lloyd’s of London insurance market was at the front of the private PRI market development. The 1970s market expanded considerably during the late 1980s and early 1990s as PRI broadened to cover contract frustration and public buyer default perils. The new PRI products became popular with banks which started buying public buyer default policies to protect their loan books in less developed countries. This contributed to market’s growth beyond Lloyd’s with new markets expanding in New York, Washington, and Europe. Today, the PRI market remains a niche and specialised industry with a total of 82 public and private PRI providers worldwide, of which 49 are the members of Berne Union (Berne Union, 2010). The UK is the largest private PRI market with a total of 34 insurance providers (Gallagher

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1 Political risks insured under the Marshall Plan were currency inconvertibility in 1948, expropriation in 1950 and political violence in 1956 (Zakariya, 1986)
The industry generates around US$1 billion in premiums annually and underwriting profit appears to be substantial (MIGA, 2010). The primary purpose of PRI is to protect investor’s rights and assets against the actions or inactions of host governments. In doing so, it also helps to promote foreign trade and contribute to the economic development of emerging markets (Jensen, 2008).

1.2 Background to the research

PRI has largely escaped the interest of mainstream academia. There are relatively few academic studies that have tried to understand the phenomenon of PRI. This could be due to difficulty in obtaining the primary and secondary data (Spagnoletti and O’Callaghan; Gordon, 2008). A great deal of work remains to be done in specific research streams such as political risk selection, pricing and contracting in the private insurance sector. The purpose of this study is to make a start in addressing these gaps in the existing risk and insurance literature on PRI business.

Prior to this study, the majority of contributions were of an atheoretical nature, thus reflecting the need to undertake empirical investigation in order to develop a deeper methodological understanding of PRI underwriting practices. Published research on the PRI industry is mainly produced by market participants such as the Multilateral Investment Guarantee Agency (MIGA) and the Organization for Economic Co-operation and Development (OECD) (see e.g., Gordon, 2008; Moran, 2004; Gentile and Valahu, 2004; Martin, 2002; Wagner, 2002; Galvao, 2001; Moran, 2001, West, 1999). This is not to say that they are of a lesser value; rather that there is a need for more objective research on the topic, which indicates a need for independent research. It is also worth mentioning that the existing PRI literature is rapidly becoming outdated (see e.g., Philips, 1968; Wheelock, 1973; Meron, 1979; Mandel, 1984; Shihate, 1985; and Zakariya, 1986). The PRI market has undergone major developments over the last few decades with new market entrants (e.g., MIGA was founded in 1988), increased product innovation (e.g., government non-payment coverage) and changes in international law relating to PRI (e.g., development in bilateral investment treaties) changing the dynamics of the market.
Three notable exceptions in the existing PRI literature that address methodological issues are Spagnoletti and O’Callaghan (2011), Gordon (2008) and DeLeonardo’s (2005) papers. Spagnoletti and O’Callaghan (2011) study the complexities of the PRI industry, in particular, the dynamics between different stakeholders. They examine the relations among insurers, investors, host governments, local communities and non-government organisations (NGOs). In doing so, they also compare the three provider types (i.e., multilateral underwriters, bilateral underwriters, and private underwriters). Spagnoletti and O’Callaghan (2011) argue that there are three circumstances in which holding a PRI policy may increase the probability of the insured encountering a political risk event. Firstly, NGOs and activists have been known to criticise PRI underwritten ventures for their lack of engagement in Corporate Social Responsibility (CSR). Despite being ideologically motivated, these organizations have the capability to undermine a firm’s reputation. The second circumstance is a lack of commitment on social and environmental issues on the part of PRI underwriters. According to Spagnoletti and O’Callaghan (2011), the vast majority of PRI providers do not require insureds to complete social and environmental impact assessments on the projects for which they are seeking coverage. The neglect and exploitation of local communities and/or environments can trigger a series of political events. The third circumstance is political risk association with moral hazard, whereby holding a PRI policy not only can affect the behaviour of insured but also the behaviour of host government. This study on PRI business differs in a number of ways. Spagnoletti and O’Callaghan (2011) use secondary data gathered from publicly available sources such as MIGA, OPIC, the Berne Union and PricewaterhouseCoopers. This study collects primary data through interviews and a semi-experimental survey that targets PRI experts. In addition, it seeks to understand the process behind the political risk underwriting which has not been addressed by Spagnoletti and O’Callaghan (2011), Gordon (2008) or DeLeonardo (2005). Gordon (2008) analyses 16 public and 63 private PRI providers using only publicly available information (i.e., information provided on the websites of public providers and the websites of the World Bank Group and of the Berne Union). Gordon’s paper gives a comprehensive overview of institutional features and policy practices of investment guarantee programmes and PRI. In line with Spagnoletti and O’Callaghan (2011), it compares the public and private segments of the PRI market. DeLeonardo (2005) also makes a comparison between public and private PRI providers but does so from a contract theory perspective. Jennifer DeLeonardo introduces and compares
public and private insurance contracts, using the OPIC, Sovereign and Zurich form contracts as examples. This study moves away from the public versus private PRI market debate. Instead, it focuses on the private PRI market underwriting practices, an under-researched area of the PRI field.

1.3 Research objective and questions

Through decades of PRI research, there has been little progress in understanding the mechanics of political risk underwriting in the private insurance sector. Most of the existing PRI literature can be divided into two streams. A number of studies focus on PRI’s worth as a risk mitigation tool (see e.g., Zakariya, 1986; Etratiaides, 1987; Russ, 1997; West, 1999; Galvao, 2001; Wagner, 2002; Minor, 2003; Coffin, 2004). The other stream compares and contrasts the types of PRI providers (see e.g., Rowat, 1992; Curtis, 1995; DeLeonardo, 2005: Gordon, 2008; Spagnoletti and O’Callaghan, 2011). There are only a few studies carried out by those close to the industry that address the issue of PRI pricing (see e.g., Palmer, 2009; Coppola, 2009; Sundberg, et al, 2009; Ascari, 2010; Rolfini and Paciotti, 2010). However, these studies are concerned with public sector pricing which may or may not be different from that of the private PRI sector pricing. Private PRI providers have to deliver returns to their shareholders, whereas public PRI providers are not altogether driven by the profit objective. This in turn can result in pricing and/or risk selection differences between the two types of PRI providers. The following questions arise out of a lack of academic knowledge within a field of the study:

1. How does the UK PRI market select political risks for a portfolio of risks?
2. What pricing methods does the UK PRI market use?
3. Which factors impact on the perceptions of political risk underwriters as to what risks are acceptable?
4. Does the UK PRI market have different levels of political risk acceptance as compared to other PRI markets?
5. Do UK political risk underwriters price political risks differently from underwriters of other markets?
Political risk violates the majority, if not all, principles of insurability (Gordon, 2008; Ascari, 2010; Spagnoletti and O’Callaghan, 2010) (see Chapter 2). Thus, it is of particular interest to understand how the underwriting mechanics work in this specialist insurance market. This leads to the main research objective of this study, set out as follows:

*The main objective of this study is to conceptualise the process of political risk underwriting in the UK private insurance market.*

A mixed method research approach will be used in this study in order to address the research questions and to meet the above objective.

### 1.4 Justification for Research

Three main reasons underpin the need for more research into the field of a study. Firstly, PRI is a profitable line of business. For example, MIGA (2011) reports that it has issued more than US$35 billion in PRI policies since its inception in 1988 and during its lifespan the agency had just six claims (MIGA, 2012). Similarly, according to the Berne Union (2012), its members have issued approximately US$277 billion in PRI policies between 2007 and 2011 and during the same period they paid out US$ 454 million in claims, but were able to recover around US$64 million, resulting in an actual payout figure of US$390 million. Assuming a conservative average premium rate of 1%, it leaves the Berne Union members with an average underwriting profit of US$1.4 billion annually. This is substantial return for a small business line like PRI (Spagnoletti and O’Callaghan, 2011). Secondly, governments and investors alike have long acknowledged the potential of PRI to play a role in fostering investment in emerging markets and its contribution to globalization and development (see e.g., Gordon, 2008; DeLeonardo, 2005). A number of foreign investments would not take place if they were not covered under PRI policies. Last but not least, the private PRI market has been largely overlooked by scholars and regulators. As mentioned earlier in this chapter, there are a number of issues associated with the existing PRI literature, which is largely incomplete and fragmented.
1.5 Methodology

This study overcomes the obstacles of a shortage of data by adopting an innovative (in the context of the risk and insurance field) research design in order to generate primary qualitative and quantitative data. It adopts a mixed-method approach with the use of both semi-structured interviews and semi-experimental survey as the main data collection methods. A qualitative grounded theory analysis was executed using data from 14 in-depth interviews and PRI market documentation (industry reports and PRI contracts). Given the lack of integrated theory in the risk and insurance literature regarding PRI and political risk underwriting, an inductive approach that allows theory to emerge from empirical data was the most appropriate. According to Glaser and Strauss (1967), the grounded theory method is ideally suited for under-researched areas. Results that emerged from the qualitative analysis have informed the development of a scenario-based survey, which was purposely designed to test and complement theories derived from the analysis (see Appendix D). In all, 104 usable research instruments were collected from PRI experts and experts from the PRI-related fields (e.g., trade credit insurance and political risk consultancy). All statistical analysis was carried out using SPSS. The mixed method approach provides the most appropriate methodology to build a framework for political risk underwriting in the UK private insurance sector. The rich qualitative and quantitative data produced by the adopted approach is central to this argument.

1.6 Outline of this thesis

In this chapter, the context of this study, research questions, motivation and methodology are introduced. The remainder of this study is outlined as follows.

_In Chapter 2_, a detailed literature review is presented, based on five sections. The first section introduces the phenomenon of political risk and suggests a working definition to be used in the PRI context. The second section discusses the notion of political risk insurability. The PRI market overview and development is presented in the third section. The fourth section compares and contrasts the three types of PRI providers where the main differences in the context of underwriting objectives, products and policy wordings are outlined. The final section of this chapter discusses the existing literature.
on the public PRI market pricing strategies. Overall, this chapter creates a platform for the discussion of political risk analysis in the PRI context.

*In Chapter 3*, the methodology of this study is explained. The mixed method approach was utilised in this research project. The first part of the chapter introduces the Grounded Theory technique (Glaser and Strauss, 1972). A number of academics argue that grounded theory analysis is particularly beneficial for under-researched topics (see e.g., Goulding, 1999; Titscher et al., 2000), which is the case with PRI. This is the main rationale behind the chosen research design. The second part of the research design involves designing the scenario-based survey. The purpose of the survey is to test and complement the grounded theory analysis results. It is the first study to have adopted the grounded theory analysis and scenario-based surveys in the PRI research domain.

*In Chapter 4*, the findings of grounded theory analysis are presented. The three main categories which emerged from the analysis are discussed in detail. The first section of the chapter discusses the category of portfolio management and its sub-categories and concepts. The second section explains the risk selection category, while the third section reveals the pricing methods that emerged from the analysis. Grounded theory analysis results informed the design of the scenario-based survey.

*In Chapter 5*, the results of the analysis of the survey replies are outlined. The survey findings are presented based on four sections. The first section outlines the profile of study participants. The second section develops hypotheses arising from the research questions. The third section reports the findings from the present study and in doing so, it also tests the research hypotheses. This results section is divided into four parts, where each part is devoted to a single hypothetical risk scenarios results analysis. The fourth part concludes the chapter. This is the first known study to explore patterns of political risk acceptance and pricing in such a manner.

*In Chapter 6*, the main findings of this study are synthesized and discussed. More particularly, the two frameworks of political risk selection and pricing in the UK private insurance sector that emerged out of the current study are summarised and explained. These frameworks are one of the original contributions of this study. The chapter also discusses the methodological approach taken to address the research questions. Overall,
it contributes a considerable amount of new literature to the field. This information is of interest, not only to academics, but also to insurance market practitioners who might be considering entering the PRI business.

In Chapter 7, the conclusion, the contributions of the study are summarised. Research limitations and future research opportunities are also presented.
CHAPTER 2: Theory of Political Risk and Political Risk Underwriting

2.1 Introduction

A substantial amount of research has been dedicated to political risk assessment and forecasting (see e.g., Simon, 1984; Hennessey, 1995; Diamonte, Liew and Stevens, 1996; Howell and Xie, 1996; and Jarvis and Griffiths, 2007). However, there is less analysis on political risk insurability and, in particular, how that risk is managed in the private insurance sector. The existing literature on political risk insurance (PRI) is fragmented and incomplete. There are major gaps in the literature on subjects of political risk selection, pricing and contracting in the insurance market. In addition to that, there are a number of concerns in regard to the literature that should be addressed at this point. Firstly, the majority of contributions are of atheoretical nature, and; secondly, the existing PRI research is mainly industry-driven (see e.g., Gordon, 2008; Moran, 2004; Gentile and Valahu, 2004; Martin, 2002; Wagner, 2002; Galvao, 2001; Moran, 2001, West, 1999)2. In other words, there is a need for more independent research into the PRI field. It is also worth mentioning that the PRI literature is rapidly becoming outdated (see e.g., Philips, 1968; Wheelock, 1973; Meron, 1979; Mandel, 1984; Shihate, 1985; and Zakariya, 1986). The purpose of this chapter is to highlight gaps in the existing PRI literature that need to be addressed in order to improve the transparency of practices of political risk underwriting in the private insurance market. This is the first study to carry out a PRI literature survey in a manner that provides a platform for the future research and endorses PRI as a separate research domain of risk and insurance field.

The chapter begins by noting traditional definitions of political risk and recommends a new definition based on an in-depth analysis of industry practice. This is one of the

2 MIGA has been particularly active in expanding knowledge in the PRI field. It has sponsored five symposiums on International Political Risk Management which proceedings of the 2000, 2002, 2004, 2006 and 2008 are published as a series by the World Bank. The five volumes are collections of papers produced, mainly, by leading practitioners from the insurance, lender and international investor communities. Therefore it does not come as a surprise to find that the largest part of the existing PRI literature is of atheoretical nature based purely on the personal/professional experience.
original contributions of this study. Furthermore, the notion of insurability in the context of political risk is explored and linked with the development of the PRI market. The key dates and different stages of the market development were established after an extensive survey of the existing PRI literature, documents and interviews with PRI market practitioners. A comparison between public and private PRI markets is also undertaken by identifying the main differences in the context of underwriting objectives, products and policy wordings. The techniques used to price PRI contracts in the public sector are presented in the following section. The chapter concludes by highlighting the gaps and shortcomings of the existing PRI literature and hence some of the research questions which this study will address.

2.2 Defining Political Risk

The term political risk has been in use for over fifty years in the international business literature. However, it has not received a clear-cut definition (see e.g., Kobrin, 1979; Fitzpatrick, 1983; Pahud de Mortanges and Allers, 1996; Alon, Gurumoorthy, Mitchell and Steen, 2006). It is neither a straightforward nor transparent phenomenon and its sources are many and varied. A number of academics, as well as industry professionals, have attempted to apply an encompassing definition. In the late 1960s and early 1970s, the first wave of academics produced a number of explanations of the phenomenon that set the foundation for political risk research. One of the first operating definitions of political risk is offered by Robock (1971, p. 7), stating that political fluctuations represent political risk only when they meet the following criteria: “(i) when discontinuities occur in the business environment, (ii) when they are difficult to anticipate and (iii) when they result from political change”. In addition, he argues that if political changes do not have any impact on the profitability or other goals of an enterprise, then those changes cannot be regarded as political risk. Similarly, Weston and Sorge’s (1972, p. 60) definition sets out that: “political risks arise from the actions of national governments which interfere with or prevent business transactions, or change the terms of agreements, or cause the confiscation of wholly or partially owned foreign business property”. Carlson (1969), Smith (1971), Eiteman and Stonehill (1973), Aliber (1975), Baglini (1976), Robock and Simmonds (1976) all explicitly or implicitly define political risk as government interference with the business-operating
environment. These definitions provide a limited explanation of the phenomenon as they mainly focus on discontinuities in the business-operating environment caused by host country political players and ignore the fact that losses can occur due to host government’s inactions as well as actions.

A second cluster of academics defines the phenomenon in terms of political events or restrictions imposed upon a foreign investor. For example, Root (1973) argues that political risk can be observed in three forms; transfer risk, operational risk and capital-control risk. Transfer risk occurs when a foreign investor is unable to convert local currency into hard currency and/or is unable to transfer products and technology from a host country. Usually, incidents of currency inconvertibility and fund transfer limitations occur due to national debt rescheduling or central bank restrictions. The second form of political risk is operational risk which arises from uncertainty around government actions, changes in policies or regulations as well as problematic administrative procedures. Investors are generally reluctant to operate in countries which do not have transparent administrative political structures or where governments have unlimited power to undermine business success. For instance, high levels of corruption can be a heavy burden on a multinational corporation, which in turn can lead into substantial loss of profits. The third form of political risk is capital-control risk which can be seen as discrimination against foreign firms. This can take a form of confiscation, expropriation, creeping expropriation or the nationalization of a foreign firm’s assets by the host government.

Kennedy (1988) takes a different approach and defines political risk as a firm’s loss of financial, strategic or personal value due to non-commercial factors. He further splits political risk into two components: legal-governmental and extra-legal risks. Legal-governmental risks are generated by political authorities and result in losses arising from foreign-exchange controls or trade regulation, while extra-legal risks are produced by events that are considered unlawful by the state, such as revolutionary expropriations or terrorism. One could argue that extra-legal risks do not constitute political risk and belong to a category of terrorism risk. Extra-legal risks are not directly caused by a government; rather they are reactions of individuals or organized organizations towards government’s actions or inactions. Generally State authorities have little control over actions of terrorist groups (unless it is state-sponsored terrorism). Jeannet and
Hennessey (1995) identify specific political actions that can interfere with foreign business operations such as: ‘buy local’ restrictions, non-tariff barriers, subsidies, operating restrictions, ownership conditions and takeovers. They also argue that there can be different motivations behind the host government’s actions, which are summarized in Table 2.1. They claim that any combination of goal and action is possible; however, some combinations are more frequently observed. For example, if a host government’s actions are driven by cultural identity, they are more likely to manifest in forms of operating restrictions and ownership conditions. Similarly, a number of studies have showed that host governments are more likely to interfere with certain types of activities such as mining, extracting, water resource management or forestry in comparison with less strategically valued industries or activities (see e.g., Lax, 1983; Southgate and Whitaker 1992; and Choharis, 2006). This approach of defining political risk in terms of events is more suitable for PRI business than the first cluster of definitions, which see political risk as discontinuities in business-operating environment.

<table>
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<th>Table 2.1: Host Government Goal and Policy Actions</th>
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<td>Goal</td>
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<td>“Buy local”</td>
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<td>Non-tariff barriers</td>
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<td>Ownership conditions</td>
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<td>Takeovers</td>
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*Source: Jeannet and Hennessey (1995, p. 116)*

Clark (1991) takes a more narrow approach and describes political risk as the non-diversifiable variations in a country’s ability to generate the net foreign exchange necessary to meet interest and principal payments on outstanding foreign debt. This definition is limited to a host government’s non-payment risk, which, arguably, is more closely linked to country’s economic risk compared with political risk as defined by Root (1973) or Jeannet and Hennessey (1995). Howell (2001) broadens the definition
by stating that political risk is the possibility that political decisions or events of political or societal origins in a host country will negatively affect the business-operating environment. This could be related back to Kennedy’s (1988) argument that political risk can be subdivided into legal-governmental risk, which is of political origin, and extra-legal risk, which is more of societal origin. Khattab et al. (2007) extend this further, incorporating political, societal and legal risks into their definition of political risk. Arguably this is too broad to be beneficial for forecasting political events as the majority, if not all, of political, legal and societal events could be considered political.

From the discussion above, it is clear that political risk has been defined from the perspective of political and social scientists. Within the insurance sector, political risk underwriters are required to undertake pricing and risk transfer decisions on specific elements of political risk. There is lack of research carried out on how PRI market participants define and perceive political risks, which is addressed in this thesis. From an in-depth analysis of industry practices, it can be concluded that PRI market tends to define political risk as a list of covered perils. As one underwriter explained:

Participant 5: Political risk for us is the perils that we insure, such as: expropriation, confiscation, political violence, currency inconvertibility and the wrong calling of guarantees.

Each peril is then defined separately in the insurance policy. The perils covered under PRI policies and their definitions will be addressed later in this chapter. One could argue that this underwriter’s definition of political risk resembles that of Root’s (1973) definition, where political risk is segregated into three types: transfer risk, operational risk and capital control risk. Nevertheless, the PRI market takes much narrower approach by covering specific events that can be attributed to the three forms of political risk. This approach helps to translate the phenomenon of political risk into definite and verifiable insurable events. However, this also implies that the PRI market definition of political risk is unable to capture the full extent of the phenomenon. Political risks outside the scope of this definition can be considered uninsurable (e.g., losses arising from corruption). For the purpose of this study, political risk is defined as the adverse host government’s action or inaction such as currency inconvertibility, expropriation, breach of contract or political violence that can have a negative impact on firm’s value.
2.3 Determinants of Political Risk

Academics and industry participants are in agreement that the determinants of political risk involve political, economic and social elements. These determinants are interlinked and interconnected with each other. This in turn makes it difficult at times to isolate and establish causation among different variables. According to Ascher and Overholt (1983), political regimes are systems of “organized complexity” with a high-level architecture of interrelations. This distinctive nature of politics calls for different systematic assessment of political and non-political trends to be incorporated into political forecasting. The current body of knowledge on political forecasting offers a great deal of academic analysis of the phenomenon, which could help develop a more complete conceptual framework of determinants of political risk. This framework could help the PRI market to develop or improve criteria for risk categorization. In this section, political risk forecasting literature is reviewed and synthesized using the structure of political, economic and social determinants, respectively.

2.3.1 Political Determinants

Political determinants are the key factors to be included in political forecasting. Henisz (2000), Jensen (2003), Ahlquist (2006) and Jakobsen (2010) all argue that political institutions represent the most important source of political risk. Central, regional or local host governments and their representative authorities have direct power to interfere with the business-operating environment. This power can be used either to endorse or suppress foreign direct investment (FDI). Tax incentives are one of the most common methods in promoting FDI inflows (Buettner and Ruf, 2007). It is unusual for host governments to actively try to discourage FDI, but policy changes can be seen as one of possible strategies in that case. In assessing political risk, political determinants can be subdivided into two groups, namely, the quality of host government and political stability.

Political regimes differ greatly in their structure, size and political beliefs. The quality of government can be benchmarked against economic factors such as economic growth, per capita income and wealth distribution, as well as social factors such as maintained
traditions and life expectancy (see e.g., Rothstein and Toerell, 2008; Holmberg, Rothstein and Nosiritousi, 2009; Charron and Lopuente, 2010; Raby and Teorell, 2010). In the PRI field the quality of government can be regarded as the government’s non-discriminatory and impartial attitudes towards foreign investors. La Porta, Lopez-de-Silanes, Shleifer and Vishny (1999) employ regression models for cross-section of countries data to investigate empirically the quality of governments. Findings of the study show that larger governments perform better than smaller governments. However, there is no evidence to suggest that expanding government size (e.g., government expenditure) will consequently result in an improvement in the quality of a government. Jarvis and Griffiths (2007) argue that military dictatorships, where legitimacy is low, can be perceived as higher political risk in comparison with democracies (i.e., associated with social unrest and the higher likelihood of violence or sudden regime change). Similarly, Vij and Kapoor (2007) state that levels of democratic accountability, transparency and quality of the bureaucracy are also important determinants of political risk profile of a host country. This is in line with Agarwal and Feils’s (2007) argument that the degree of red tape (e.g. the extent of layers of operational/administrative rules and procedures) and the level of corruption and bribe in a host country can have a direct impact on a multinational’s financial performance. A firm operating in corrupt country faces a risk that corruption and bribe demands will increase over time, which in turn can lead to severe losses.

A number of scholars have suggested that political stability is one of the key elements in political risk assessment (see e.g., Robock, 1971; Bunn and Mustafaoglu, 1978; Overholt, 1982; Henisz and Delios, 2001; Vij and Kapoor, 2007; Jarvis and Griffiths, 2007). Ake (1975, p. 273) defines political stability as “the regularity of the flow of political exchanges”. In order to determine the extent of political stability, one has to be able methodically to classify both irregularities and regularities in host country political patterns. A government is stable to the extent to which its regime components are stable (Overholt, 1982). Irregularities can result from a number of factors, such as abrupt changes in ruling elite or coalition supporting the ruling elite and its institutions, as well as from changes in the ideology that connects the ruling elite, coalition, host country institutions and society. It is important to stress that opposing organizations and their strategies can have an impact on political stability too and, therefore, should be included in political forecasting. In addition, Kaksoon (2010) states that corruption index from
International Country Risk Guide (ICRG), *political rights index* from Freedom of the World, 1996, and *democracy index* from Polity III: Regime Type and Political Authority, 1800-1994, are good measures of political stability. One could argue that an assessment of political stability should be carried out in the broader context. External factors such as economic circumstances, social developments, and international relationships and internal factors like political exchanges of coalition and opposition all can affect a host government’s stability (Ascher and Overholt, 1983). The relative power of the ruling leadership, coalition, opposition and governmental institutions vary from country to country and over time. Each country should be analysed separately and in comparison with other countries in order to gain the sense of overall structure of a given country’s polity and stability.

### 2.3.2 Economic Determinants

Political forecasting is a challenging task which is not limited to an analysis of political stability, the quality of a government and its institutions. The level of political risk in a given country can increase in response to the changes in economic environment, which in turn can result in both civil unrest and the host government's interference with the business-operating environment. Robock (1971) argues that political events such as currency inconvertibility can occur due to economic pressures even in politically stable countries. Jarvis and Griffiths (2007) review the evolution of four generations of political risk assessment in the post-war period. They find evidence in the political science field which suggests that under particular circumstances such as an absence of political development, the inability of a government to accommodate demands of powerful emerging constituencies and rapid economic modernization can generate political risk. Similarly, Agarwal and Feils (2007), Vij and Kapoor (2007), Hefeker (2007), Cosset and Roy (1991) and Bunn and Mustafaoglu (1978) argue that positive economic growth is associated with lower levels of political risk. A government in distressed economy might be running out of options to calm volatile financial markets or civil unrest. This in turn can encourage it to engage in more radical approaches of crisis management. In times of economic or financial crises, multinationals are put in a more vulnerable position compared with local investors, as nationalistic trends tend to rise in favour of local markets (e.g., imposition of capital controls in Malaysia in 1997).
Factors like balance of payment, external debt, foreign exchange rate and inflation also have been shown to contribute to predictability of political events (see e.g., Agarwal and Feils, 2007; De la Torre and Neckar, 1988).

### 2.3.3 Social Determinants

In the past, practitioners of political forecasting and academics have focused their research on political and economic determinants of political risk (De la Torre and Neckar, 1988; Schmidt, 1986). However, more recent studies show that factors as social fairness, rising education levels, and religious/political freedom can be better predictors of overall political stability in a long term (Galvao, 2001). Positive economic growth in itself does not guarantee political security. From a foreign investor point of view, it is not sufficient to check a country's sovereign rating and build up a good relationship with incumbent political parties in order to assure smooth operation environment. Political unrest, labour problems, strikes can all result in direct or indirect losses (Jarvis and Griffiths, 2007). Rarick (2000), Olzak and Shanahan (1998) and Fording (1997) argue that income inequality amongst identifiable ethnic groups within a broader society can trigger social disorder. Similarly, Busse and Hefeker’s (2007) findings suggest that, among other variables such as government’s stability, a country's legal system and ethnic tension are significant determinants of levels of political risk. Goldstone et al (2010) claim that they have managed to develop a model capable of forecasting the onset of political instability with two-year lead time. Their model suggests that infant mortality rate and discrimination are significant factors in predicting political instability.

As mentioned earlier, there has been a significant amount of work published on different factors affecting political risk; however, a large proportion of it is of qualitative nature. Thus there is a need for more quantitative work done in the area (where methodology permits) to test just how strong/significant those factors are in political forecasting.

The next section discusses issues associated with political risk insurability.
2.4 Political Risk Insurability

An “insurable risk” term is one of the main concepts in the practice and theory of insurance. A risk has to satisfy certain criteria to be capable of being insured profitably over the long run. The key principles of insurability are: randomness (e.g., it is of fortuitous nature where the occurrence of a loss is entirely independent of the will of an insured); accessibility (e.g., it is possible to quantify probability and severity of claimable events); mutuality of interest (e.g., there are large homogeneous groups exposed to a given hazard within which the risk is shared and diversified in economically fair manner); and affordability (e.g., the premium is a reasonable premium in relation to an insured’s financial risk) (Coomber, 2006; and Bennett, 2004).

Political risk violates a majority, if not all, of the principles of insurability (Ascari, 2010; and Gordon, 2008). According to Gordon (2008), insured political events may be under the control of an insured, up to a certain degree. At times multinationals can have a role to play in how political events will unfold. Political risk is ill-suited for statistical analysis due to its discontinuity in trend, not to mention an inherent component of human nature. The OPIC insurance claims history can be used to illustrate the changing nature of political risk (see figure 2.1). For example, in early-mid 1980s, the majority of OPIC’s claim payments were due to currency inconvertibility peril which completely disappeared in mid-late 1990s. Political risk exposure units are not homogeneous, that is, the frequency of a loss and severity of a loss are idiosyncratic for every insured. They can be influenced by a number of factors, such as host country’s political environment, the industry in which the risk is situated, and the insured-host government relationship. For example, two foreign investors of a similar business profile operating in the same industry both seeking PRI coverage against an adverse host government’s actions or inactions can be rather incomparable if one investor’s home government has a good relationship with the host government and the other has a long history of political and/or economic conflict.
Figure 2.1: The Overseas Private Investment Corporation (OPIC) insurance claims experience throughout 1966 to 2009.

SOURCE: Overseas Private Investment Corporation 2010
An insured loss event in some cases is not definite or objective. In other words, there are times when it is not clear if a host government’s actions or inactions were deliberately targeted towards a particular insured, or if it has affected every investor in the host country (e.g. was it a non-discriminatory act and, if not, was this loss covered and should a PRI provider be considered liable for that loss). It is important to note that commercial risks, like changes in production, material prices, and interest rates, do not constitute political risk. There are no universal legal definitions for PRI perils such as creeping expropriation which at times makes it difficult to defend against a host government’s wrongdoing. The definitional issues in PRI contracting will be further explored later in this chapter.

Despite these deviations from the principles of insurability, the PRI market has been operational for a number of decades. It has survived the devaluation of the Mexican Peso in 1982, the Asian crisis in 1997 and the Argentine economic crisis in 2001, however not without major industry insured losses. One well-documented case is that of Ponderosa Assets, L.P., which has received a claim payment in the amount of US$50,000,000 from OPIC in 2002. One could argue that the PRI market has proven that its business model works not only in benign times, but is also able to withstand and absorb catastrophic losses. The next section will give a comprehensive overview of PRI industry.

2.5 An Overview of the PRI Industry

PRI is a risk mitigation tool designed to protect firms against specified political risks associated with investing abroad. It is a niche and complex market which can be subdivided into three provider types: national government agencies such as the US OPIC, the UK Export Credit Guarantee Department (ECGD) and the Australian government’s

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3 In 2002, Ponderosa filed the application for the expropriation of its equity interest in an investment in the privatization, acquisition and operation of Transportadora de Gas del Sur (“TGS”), a gas pipeline company located in southern Argentina. Ponderosa had an agreement with the government of Argentina (the “GOA”) which granted TGS its rights to transport gas through a gas transportation licence. The licence specified that tariffs would be calculated in U.S. dollars and expressed in Argentine pesos. On January 6, 2002, The GOA enacted the Public Emergency and Exchange Regime Reform Law No. 25,561, which resulted in prices and rates being fixed in pesos at a one peso ($1) = one dollar (US$) exchange rate. OPIC’s conclusion was that the actions of the GOA in enacting the Emergency Law constituted repudiation of the GOA’s contract with Ponderosa motivated by non-commercial considerations and for which compensatory damages were not paid.
Export Finance and Insurance Corporation (EFIC); the private PRI market with companies such as Sovereign, Zurich, Chartis and ACE being the largest private source insurers; and multilateral PRI providers such as the Multilateral Investment Guarantee Agency (MIGA) and the African Trade Insurance Agency (ATI). In total, there are 82 public and private PRI providers worldwide, of which 42 are members of the Berne Union (Berne Union, 2011).

The PRI market has undergone three phases of development. According to Hansen (2005, p.12), the origins of the contemporary market can be traced back to the Marshall Plan in 1948, under which the US government offered to provide coverage against certain political risks for its investors investing into post-war Europe. Political risks insured under the agreement were currency inconvertibility in 1948, expropriation in 1950 and political violence in 1956 (Zakariya, 1986). In late 1940s to late 1960s, the market comprised mainly of public PRI providers with private PRI insurers being an exception rather than being a separate subsection of the market. It was long thought that government agencies were inherently better positioned to provide PRI coverage than private insurers. Governments would have an access to the information that was not readily available to private insurers. They would also have better chances of persuading a host government to compensate an insured investor for the losses occurred. This perception remained present throughout the 1970s, which was a phase of “the true birth of the private PRI industry” (DeLeonardo, 2005; p.742). It is important to acknowledge that Lloyd’s of London insurance market has been providing some coverage for political risk since 1940s, but it was a clause under marine insurance policy coverage rather than a separate line of business. The private market expansion did not start until 1971, the year when Lloyd’s signed a reinsurance agreement with OPIC. The market further penetrated the US where Chartis, a subsidiary of the American International Group (AIG), had become a first significant private entity entry into the PRI market in 1978. The second expansion of the private sector was in the 1990s, during which a number of new market entries were welcomed (Hansen, 2005). The main reason for the private market development was to fill in the gaps where public source providers were not willing or able to provide coverage. As a result, investors who could not obtain publicly provided insurance sought out private insurance products. There were two main concerns raised over the effectiveness and ability of the private market to insure political risks at the time. The first argument was that private PRI market providers
were less well equipped to assess and measure political risks. Governments have a competitive advantage in gathering information on a host country’s foreign investment regimes, as they can capitalize on their diplomatic ties. The second argument was that the private providers had insufficient capacity to absorb potential losses arising from insured political events. The private market was hit hard by a number of international crises in 1982, 1997 and 2001, during which the market paid out a substantial amount of compensations and a number of private PRI providers disappeared. Nevertheless, it has survived and grown considerably since then. The latest development of PRI market can be attributed to an emergence of multilateral PRI providers in late 1980s. MIGA, a monoline insurer, was established in 1988 and was later joined by the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), ATI, and the Arab Investment and Export Credit Guarantee Corporation (DHAMAN) multilateral providers entries.

The role of the private PRI market has evolved substantially over the last 20 years, with private source insurers taking on increasing shares of the PRI market. Perry (1996) reports that the size of the entire private PRI market was only marginally larger than the OPIC’s business alone in mid-1990s. In 2001, all public source insurance accounted for only 52 per cent of the global PRI market, while private insurance companies accounted for 48 per cent, which was a significant increase of the private PRI market share (Westholm-Schroder, 2001). Arthur J. Gallagher & Co (2011), a risk management and insurance broking company, reports a similar trend in increasing private market’s capacity over the last ten years (see figure 2.2). This growth can be attributed to a number of factors. Information asymmetry between public source and private source insurers has been reduced. There is more useful information on host countries and different sectors readily available through different media channels. In addition, a number of intelligence and consulting agencies (e.g., the Economist Intelligence Unit, Global insight and Control Risks) have emerged over the last fifty years that provide consultancy services to the private PRI market. Lastly, DeLeonardo (2005) claims that changes in international law (e.g., improvements in arbitration laws), establishment of international juridical bodies such as an International Centre for Settlement of Investment Disputes (ICSID) and popularity of bilateral investment treaties have been the biggest contributing factors to private PRI market growth.
The PRI market is highly heterogeneous with major differences between the three provider types and within the types themselves that will be explored in the next section.

2.6 Private PRI Market versus Public PRI Market

There are a number of institutional and practical differences between public and private PRI market participants which are addressed by Spagnoletti and O’Callaghan (2011), Gordon (2008), DeLeonardo (2005) and West (1999). This part will briefly compare the public and private source PRI programmes.

The existing PRI literature is rather consistent in arguing that publicly-sponsored PRI programmes have a number of advantages over the private source programmes. One of the key distinctive features of public source PRI programmes is the underlying purpose of their existence. Gordon (2008) utilises a sample of 16 providers of publicly sponsored guarantees and PRI programmes, of which 13 were OECD countries and 3 non-OECD countries. The findings show that enhancing home country’s economic performance is a primary objective of all 16 public PRI providers. Another goal mentioned in the US, Australia and Japan agencies’ mission statements is to “fill the
“gap” created by incomplete private insurance coverage. For example, the Australian Government’s Export Finance and Insurance Corporation (EFIC) mission statement reads as follows:

*Overcoming financial barriers for exporters by providing financial solutions, risk management options and professional advice, when the private market lacks capacity or willingness, we create opportunities for Australian exporters and offshore investors to grow their international business.*

The governments of the US, Australia and Japan position themselves as “insurers of last resort”, rather than directly competing with the private PRI market. This prevents the ‘crowding out’ of the private insurers. One could argue that this approach of “insurer of last resort” encourages the development and growth of the private PRI sector. According to Gordon (2008), out of 16 governments only the US OPIC has host country’s development as its primary mission, which is the following:

*The Overseas Private Investment Corporation’s (OPIC) mission is to solve critical world challenges by catalyzing markets in developing nations. OPIC accomplishes its mission by delivering finance innovations that help ambitious U.S. businesses successfully enter, grow and compete in emerging markets.*

OPIC is not the only organisation of this nature that is motivated to contribute to the economic development of emerging markets. The World Bank Group’s MIGA was established in 1988 for this purpose, which is:

*MIGA’s mission is to promote foreign direct investment (FDI) into developing countries to support economic growth, reduce poverty, and improve people’s lives.*

Te Velde (2003) and Rowat (1992) state that PRI can contribute to the promotion of FDI inflows into the Less Developed Countries (LDC). Te Velde (2003) also adds that the relative importance of PRI can vary from one sector to another. For example, projects involving high sunk cost (e.g., power and water sectors) are more vulnerable to political risk than projects with smaller sunk costs (e.g., services and manufacturing). Meron (1979) argues that of the two types of PRI providers public sector insurers are better at promoting development. Similarly, Hansen (2005) argues that private insurers do not possess the same ability to bridge sovereign risks as their multilateral and bilateral counterparts do, and consequently their focus is centred on less risky projects and markets. This implies that public PRI providers contribute more towards the
development of emerging markets. However, there are inherent limitations in the public PRI programmes, which are imposed by their sponsoring governments in a form of investor eligibility requirements (Rowat, 1992). An investor may not be eligible for national PRI programme if a project is located in a country which is not covered by the national programme or if the investor is not a citizen of the sponsor government. For instance, Japanese companies incorporated in the US are not eligible for Japanese coverage and US companies that have been acquired by Japanese buyers are no longer eligible for OPIC coverage.

With respect to coverage provided by private markets, Gordon (2008) introduces a ‘missing markets’ term, which is a condition that favours government’s intervention in markets. Private PRI providers are exposed to high transaction costs such as risk evaluation, packaging, contracting, monitoring, and claims management. Due to these potentially high transaction costs, the private market is not able to insure small risks or high risks that are in excess of a certain limit, as this could threaten a company’s solvency position. Governments, on the other hand, can still be able or willing to insure risks involving high transaction costs. That does not imply that governments do not incur the same costs, which they do. Instead, public insurers’ underwriting decisions are often motivated by objectives other than profit maximisation. For example, ONDD, the Belgian government’s guarantees and investment insurance agency, issues insurance policies with an objective to foster country’s diplomatic ties. The objectives of private insurance sector are ultimately different from those of the public sector, which can have an impact or risk selection. The private PRI market has to adopt a profitable business plan in order to verify its existence, whereas the public sector is concerned with enhancing home country economic performance, filling gaps in private sector cover, promoting development of host countries and/or realising diplomatic objectives (Gordon, 2008). Meron (1979) claims that one disadvantage of national PRI programmes is that they might be forced or allowed to engage in political protectionist measures such as by not insuring particular industries or projects that can have negative impact on the key domestic industries. For example, OPIC may not provide insurance for any investment involving citrus crops, palm oil, or sugar for export. These underlying objectives of public and private PRI market providers in turn have an impact on how political risks are priced and selected for the portfolio of risks.
Existing studies produced by Meron (1979), Rowat (1992), West (1999), Te Velde (2003) and Hansen (2005) share a common characteristic. Their analysis is not founded on a robust methodology. That is, they do not use research methods or disclose what data they are using to support their arguments in regards to the PRI business. Their proposition that public source PRI programmes are at an advantage over private source PRI programmes remains to be proven. It could have been a case that governments were better positioned to provide investment insurance a number of decades ago. However, there is also evidence to suggest that private PRI market providers have progressed in a number of areas such as contracting, increasing capacity and pricing techniques. They have also been able to learn and improve from cooperation with the public PRI providers while co-insuring large projects. In addition, public PRI provider’s underwriting decisions are restricted by public mandate and eligibility requirements, which in turn limit what investments can be insured. Private PRI providers have fewer restrictions and so can be more flexible in their underwriting decision-making process. Therefore it could be misleading to state that public PRI programmes have distinctive advantages, while providing no evidence to support the argument.

2.7 Political Risk Insurance Products

There are a number of publications that provide a synopsis of political risk perils covered under PRI policies (see e.g., DeLeonardo, 2005; Martin, 2002; Galvao, 2001; West, 1999). PRI generally protects against four main perils: (1) currency inconvertibility and transfer restrictions; (2) confiscation, expropriation, and nationalization; (3) breach of contract; and (4) political violence. The majority of contributions made to the study of PRI products do not go into much detail and specifics of each peril (see, e.g., Martin, 2002; Galvao, 2001; and West 1999). DeLeonardo (2005)\(^4\) is a notable exception in the existing PRI literature, as it gives a technical evaluation of the currency inconvertibility, expropriation and political violence perils. It also makes a comparison between public and private PRI providers’ definitions of the perils. This part of the chapter builds on the work of DeLeonardo (2005) by expanding it to include the forth peril, which is the breach of contract, using MIGA’s contract form

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4 DeLeonardo (2005) uses Sovereign and Zurich policies as examples of the private market contracts and OPIC policy as an example of state sponsored PRI.
as an example. The full form of MIGA PRI contract is included in Appendix E. It is important to note that there are no standard definitions of the perils. Therefore, it does not come as a surprise that, to a larger or smaller extent, the definitions tend to vary from one insurer to the next.

2.7.1 Confiscation, Expropriation, and Nationalization

Confiscation, expropriation, and nationalization are traditional PRI policy perils, which are variations of each other. A seizure of private asset by a host government for public use without compensation is considered confiscation. Expropriation is a confiscation of private asset by the government for public use with compensation, while nationalization is a takeover of foreign companies or their assets at a larger scale (Torrado, 2005). Galvao (2001) argues that even though expropriation risk is catastrophic by nature, it has been diminishing over recent decades due to improvements in international law (e.g., the World Trade Organisation (WTO) policies of arbitration and awards). Indeed, the nature of expropriation risk has changed. In 1950s most acts of expropriation were outright exploitations, where governments would physically take over investors’ assets and/or their rights (Minor, 2003). An outright expropriation is a rare event in the present time. Governments tend to act in more indirect ways, such as imposing discriminatory taxes, changing regulations or law, or cancelling export/import licences, which are not necessarily expropriation, but can severely paralyse foreign investor’s project (Martin, 2002). This in turn can result in so-called creeping expropriation.

Generally, both public and private PRI programmes cover outright expropriation and creeping expropriation. Private market PRI providers tend to separate outright and creeping expropriation into two clauses, in contrast to the public sector which is more inclined to incorporate two forms of expropriation into one clause (DeLeonardo, 2005). For example, MIGA’s PRI policy covers:

\[ A \text{ Loss due to any legislative action or any executive or administrative action or omission (but excluding any judicial action or omission), in one or a series of events, attributable to the Host Government which, directly or indirectly: deprives or prevents the Guarantee Holder from exercising its ownership rights in, or effective control of, all or a substantial portion of the Guaranteed Investment. } \]
OPIC takes a similar approach by covering against expropriation as “an act or series of acts... attributable to a foreign governing authority... [that] are violations of international law... or material breaches of local law” (as seen in DeLeonardo, 2005; p. 748). This is different from the private PRI market forms which usually categorise expropriation into the outright expropriation, and creeping expropriation clauses. Zurich, for example, has two clauses for expropriation, where outright expropriation is defined as any actions that “effectively deprive [] the Insured of all or part of its Insured Interest in the Foreign Enterprise relating the Project” and creeping expropriation as “effectively prevent or restrict, through financial, regulatory or other measures, the operation of the Foreign Enterprise relating to the Project, causing the total cessation of the Foreign Enterprise’s operations relating to the Project” (as seen in DeLeonardo, 2005; p. 749). This approach by separating expropriation into two forms gives PRI insurers more control over the coverage they provide. Insurers can choose whether they will include creeping expropriation in the PRI policy or not on an individual insured basis. There are a number of issues associated with creeping expropriation coverage that can cause problems to PRI providers. Creeping expropriation does not have a clear-cut definition. It can take multiple forms from country to country (and within each country). Thus it can at times be difficult to prove if an expropriation act did or did not take place. This is in turn introduces an element of ambiguity in PRI contracting.

2.7.2 Currency Inconvertibility

Currency inconvertibility peril protects investors against inability to convert local currency into hard currency (e.g. dollars, pounds or euros) and/or if investors are restricted to transfer funds (e.g., dividends, profits or proceeds) from the host country (Hollywood, 1992). For example, MIGA’s provision indemnifies an insured party for:

A Loss due to any action or inaction by: (i) the Host Government or (ii) entities authorized by the Host Government under the laws of the Host Country to engage in foreign exchange transactions, in either case which prevents, directly or indirectly, both the Guarantee Holder and the Project Enterprise from legally: (a) converting into the Guarantee Currency the Local Currency <...>; or transferring outside of the Host Country the Guarantee Currency constituting a return of, or a return on, the Guaranteed Investment.
Currency inconvertibility can take active or passive forms. Active currency inconvertibility can be classified as host government’s affirmative steps to prevent a foreign investor from converting local currency into hard currency. In contrast, passive currency inconvertibility can be loosely defined as a host government’s failure to act or to cause undue delays in conversion or transfer. DeLeonardo (2005) reports that both private and public source insurers cover active and passive currency convertibility. Similarly as with the expropriation peril the private sector prefers to use more explicit language to define currency inconvertibility (e.g., breaking active and passive inconvertibility into two clauses). There is little published on the different forms of currency inconvertibility risk. DeLeonardo (2005) is the first to address this issue in the PRI context. The PRI sector, as well as academia, would benefit greatly from further research in this area.

### 2.7.3 Breach of Contract

Breach of contract peril protects an investor against losses arising from host country government’s breach or repudiation of a contract with the investor (Irwin, 1997). In other words, the coverage deals with the possibility that an insured will suffer the loss of business income or assets as a result of a host government’s non-honouring of a production sharing agreement, contract of work, concession agreement, etc. (Hollywood, 1992). MIGA’s contract covers breach of contract as:

“A Loss that is direct and immediate result of the inability of the Guarantee Holder [] to enforce an Award rendered in its favour against the Host Government, provided that the Guarantee Holder [] have made all reasonable efforts to enforce the Award against the Host Government, including initiating and participating in appropriate judicial proceedings, for the duration of the Waiting Period”

The peril is a newest addition to the PRI contracting. Martin (2002) refers to it as PRI providers’ attempt to enhance the expropriation coverage. Traditionally expropriation peril was designed to protect an investor against host government’s seizing of the investor’s project or assets without prompt satisfactory compensation. This type of coverage is not sufficient for projects that are in partnership with a host government (e.g., infrastructure or green-field projects) as the real risk lies in a host government not
meeting its obligations. The breach of contract coverage, to a large degree, addresses this hole in the expropriation coverage.

2.7.4 Political Violence

Political violence losses refer to losses arising from property damage or business interruption as a result of political motivated violence acts. According to DeLeonardo (2005), private sector providers prefer to define political violence peril as a list of distinctive events such as revolution, civil commotion, insurrection, riot, terrorism, rebellion, strike or sabotage. Public PRI providers seem to prefer a broader definition of political violence so that the definition can broaden over time in tandem with international law. Unlike the other PRI providers, MIGA use slightly different terminology. It covers war and civil disturbance peril as opposed to political violence peril. However, the two perils provide relatively equivalent coverage. This again shows the non-standardised nature of the PRI industry. MIGA’s contract defines war and civil disturbance peril as:

*The guarantee against War and Civil Disturbance shall cover a Loss due to [] “Loss of Assets”, [] “Temporary Loss of Income”, and [] “Permanent Loss of Use”, provided that the Loss is a direct and immediate result of acts of war, revolution, insurrection, civil war, civil commotion, riots or acts of terrorism or sabotage carried out, in each case, by those primarily pursuing political or ideological objectives in the Host Country, including acts against the government of the country of the Guarantee Holder, the nationality of the Guarantee Holder, or any other foreign government or foreign investment.*

MIGA’s political violence peril wording seems to provide broader coverage by covering loses that are a result of both political and ideological objectives, whereas the private PRI market tends to limit it to only politically-motivated acts. However, MIGA also requires that a loss would be ‘a direct and immediate result’ of covered events, which in turn imposes some limitations on the coverage.

2.8 Political Risk Insurance Contracting

PRI is a specialised insurance market where insurance policies are tailored to the needs of individual insureds. There are no standard PRI policy wordings and they tend to vary from one PRI provider to another. Providing a perspective from international law,
DeLeonardo (2005) analyses PRI policies taken from three providers: Zurich and Sovereign, and OPIC. All three insurers provide coverage for expropriation, currency inconvertibility and political violence perils, which were discussed in detail in the previous section. The policy wordings are comparable in terms of definitions of triggering events, limitations, exclusions and requirements for a claim payment. However, there are also a number of differences. For example, the way a currency exchange rate is calculated on the compensated amount, Sovereign uses an average exchange rate over the 180 days prior to the claim and Zurich uses a historic rate as of 180 days prior to the claim. OPIC employs the exchange rate on the day 60 days prior to the claim. In addition, the scope of the private insurance cover is narrower as compared with OPIC’s coverage, which employs broader definitions of the perils covered. To illustrate the point, OPIC defines political violence as “any violent act undertaken with the primary intent of achieving a political objective” whereas Sovereign narrows it down to a list of political events such as “war (declared or undeclared), revolution, insurrection, civil war, civil strife of a lesser degree, terrorism and sabotage” (DeLeonardo, 2005, p. 749). OPIC’s peril definitions are purposely vague so that they can be more easily modified in line with the changes in international law. The other major issue in the PRI contracting is causation standards which vary significantly across and within the PRI contracts. According to Hansen (2005, p.16), the causation of a loss may be required to be “direct”, “direct and immediate”, “sole and direct” or “exclusive”. This in turn can lead to a dispute over a claim if causation wording is not clearly defined or if an insurer believes that a covered risk is outside the scope of the coverage. The Asian Development Bank removes the ambiguity in contracting by simply requiring that the insured loss is “caused by” the peril covered with no further limitations (Hansen, 2005). Generally, the private PRI sector prefers more detailed contracting by tailoring each contract to the needs of individual insureds in comparison with public sector wordings (Gordon, 2008). Deleonardo (2005) argues that the main drawback of private PRI contracts is the tenor (i.e., the length of contract term). OPIC can issue insurance contract up to twenty years in comparison with private insurers that tend to offer tenor up to 7 years and only a few private providers would be able to insure project up to fifteen years. This can be seen from Figure 2.3, which illustrates how available capacity per risk is decreasing in relation to a tenor in the private PRI market.
Figure 2.3: Total capacity available per risk by tenor in the London PRI market (2010)

Hansen (2005) argues that there is a mismatch between the supply side and the demand side of the PRI business. State PRI schemes are still focusing on traditional political risk perils (e.g., expropriation and currency inconvertibility), which were relevant in 1950s and 1960s, but are of much lesser concern to international investors in the current political climate. For example, a risk of currency inconvertibility has diminished in recent decades as more currencies are becoming free floating, which does not require constant host government’s intervention. International investors are demanding coverage that protects them against breach of contract, currency devaluation, regulatory and licensing risks. Nolan, Sourgens, and Totino (2011) state that both the public and private insurers are trying to adjust their PRI contracts in order to expand the scope of their coverage to reflect the changing nature of political risk. Private PRI providers are particularly active in an area of product innovation as they are not constrained by public mandate. This in turn allows them to be more flexible and responsive to their clients’ demands. In order to meet recent demands, Sovereign, an international political risk insurer and reinsurer, has expanded its PRI programme to include coverage such as sovereign and sub-sovereign non-payment and political violence. In addition, Spagnoletti and O’Callaghan (2011) suggest that PRI providers should improve their PRI contracting by including environmental clauses into their contracts. PRI
underwriters, with an exception of MIGA and OPIC, have shown little commitment to social and environmental issues. PRI insurance applicants are not expressly required by underwriters to fill in comprehensive environmental and social impact evaluations on the projects for which they are requesting coverage. OPIC and MIGA now ensure that projects they insure adhere to sound social and environmental guidelines. For example, OPIC’s PRI contracts include clauses on environmental and social impact that take precedence over commercial and reputational interests of an insured. In other words, OPIC is not liable to indemnify an insured party if the insured breached or did not comply with environmental and social clauses set out in a PRI policy. Spagnoletti and O’Callaghan (2011) argue that both PRI insurers and insureds can potentially reduce political risk if they actively engage in the environmental and social protection.

There are a number of difficulties associated with studying PRI contracts in action. Insureds are generally compelled not to disclose the existence of PRI policy. As Kantor (2008, p. 139) notes, a typical policy issued by a private PRI underwriter will demand that:

The Insured shall not disclose the existence of this insurance policy to any third party, with the exception of the Insured’s bankers and other professional advisors on a confidential basis, without the prior written consent of the Underwriter.

Given the fact that there are non-disclosure agreements in place, as well as that PRI policies are tailored to the needs of individual clients, it is near to impossible to carry out any large-scale comparative study on the topic of PRI contracting.

2.9 Intrinsic Values of Political Risk Insurance

It is important to address an added value of PRI coverage in risk management process. A number of academics argue that PRI has additional risk mitigation features, such as deterrence and leverage values, in addition to its compensatory worth (see e.g., Rowat, 1992; West, 1996; West, 1999; Minor, 2003; Hansen, 2005). Deterrence value could be seen as an insurer’s role in the settlement of investment disputes with a host country. In other words, an insurer acts as a mediator between insured and host government. Minor (2003), Rowat (1992) and Hansen (2005) argue that public PRI providers are more equipped to exercise their deterrence power than are the commercial PRI insurers, due
to their intergovernmental links. There are both "positive" and "negative" aspects to this deterrent effect (West, 1999). With respect to the positive aspects, a host government might not want to complicate its relationship with a home country by engaging in messy disputes or claims involving the home state insurer. There are reputational costs associated with that which could make it more difficult in the future for the host country to borrow or attract new foreign investment from the home country and other international capital markets. In this case the deterrent value can be seen as a risk mitigation utility which can prevent claims arising in the first place. Over the 1988-2009 period MIGA only had three claims out of 580 projects that have received its support. In only 60 cases were these 580 projects treated as possible claims, but in which no claims has been paid (MIGA, 2009). The negative aspect of the deterrence affect is that it could be difficult or impossible for an investor to get insurance under the national PRI scheme if there is an unresolved investment dispute or claim with a host country. Some states have restrictions that can range from temporary hold-ups of a particular PRI coverage to complete termination of all PRI schemes against states that have not effectively compensated their national insurers (West, 1999). The deterrence value is not well documented (i.e., there is no data on “near claim cases”). Therefore it is difficult to say, with any precision, how big of a part deterrence value plays in resolving investment disputes as well as preventing claims arising or how, indeed, does it vary across different multinational, national and commercial PRI providers.

From the equity investor’s point of view, the existence of PRI policy can help to attract more favourable financing terms for a project. This can be seen as an added value of PRI coverage i.e. the leverage value (West, 1999). In many cases banks would ask borrowers to arrange PRI cover for a project/investment before they agree to finance it. Lenders (mainly banks) themselves are also buyers of PRI products as it allows them significantly to reduce or completely eliminate provisional requirements for country risk under Basel II banking regulations. Hansen (2005), after reviewing troubled insured investments of which some have resulted in claims, concludes that PRI coverage can have both positive and negative effects on a loan restructuring. The existing PRI coverage ensures lenders that they can count on at least one aspect of the deal’s original

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3 The Russian Directive of August 26 in 1998 which excluded the projects insured by MIGA from the temporary restrictions on residents’ operations involving capital movements (article 8.1 of that Directive), in order not to upset the World Bank
risk profile, which can be an irreplaceable resource, especially if the host country’s political situation has deteriorated since the financing closed. The existing PRI policy can also be used as bargaining tool in debt restructuring. From the negative aspect, the existence of PRI in a transaction, especially if some but not all parties are insured, can also be a source of a variety of obstacles in achieving a successful restructuring. Some issues mentioned by Hansen (2005) are inter-creditor conflicts, assignment issues, material amendments, and disclosure concerns.

2.10 Pricing of Political Risks in the Insurance Market

Political risk pricing is a well-kept secret in the private insurance sector (Coppola, 2009). However, more recently Palmer (2009), Coppola (2009), Sundberg, Quraishi and Choudhury (2009) and Ascari (2010), all representatives of the industry, have made a notable contribution to the knowledge of PRI contract pricing. These authors are primarily focused on the public sector pricing strategies and make only light reference to the practices of those in the private sector. This gap in the literature will be addressed in the present study.

The existing literature on PRI business summarises the pricing process as a “combination of art and science” (Palmer, 2009; Coppola, 2009; Sundberg, et al, 2009; and Ascari, 2010). Political pricing is not based on actuarial principles of insurance. There are a number of factors that limit the use of actuarial methods such as: (1) PRI losses are generally high-severity-low-frequency; (2) historical claims data is limited; (3) heterogeneous nature of PRI products; and (4) a role of recoveries. According to Coppola (2009), the lack of publicly available data on PRI losses is the major obstacle for the development of an actuarial pricing model. PRI providers tend not to disclose or share their claims data with other insurers as it is, generally, incorporated in their

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6 For example, an insured €80 million project loan against political risks is in trouble and faces a €15 million cost overrun. A bankrupt sponsor is incapable of carrying out its completion guaranty. The lenders agree to exchange €15 million of their debt for equity. This in turn lowers the outstanding project debt to €65 million. They can then seek €15 million of fresh senior debt to finance completion and initial operations of the project. Instead of losing the benefit of €15 million of insurance coverage on the debt reduction, that coverage could be offered as an incentive to the new lenders. The existing PRI policy is bound to be a bargain. It is very doubtful that the PRI providers would be willing to offer the investors the same terms as those offered for the original closing. The PRI market tends to perceive troubled investments as more likely to run into political problems even if the host country political environment is relatively benign.
pricing strategy (Sundberg, et al, 2009). If disclosed, such data could result in a significant loss of competitive advantage. OPIC is the only source that has published its claims history of thirty years. Consequently, MIGA and Zurich have incorporated OPIC’s claims data in their in-house pricing models (Coppola, 2009). The other problem associated with PRI claims data is that even if the data on losses arising from single insurance policies is made available, it still covers multiple investments in a number of countries. Thus, one would have to take into account an issue of homogeneity of the insured losses data.

According to Ascari (2010), the PRI market adopts two approaches to pricing. The first approach is based on benchmarking techniques, which is also addressed in Palmer (2009). PRI underwriters use prices of credit default swaps (CDS) and spreads on sovereign bond yields as benchmarks for their pricing strategies. In addition, Palmer’s (2009) findings show that a majority of public PRI providers refer to the OECD country ratings as a benchmark to minimum premium rates. The problem with OECD country ratings is that they are not updated frequently enough. The benchmarking approach is better suited to political risks that are more economic/financial in nature (e.g., government non-payment risk or currency inconvertibility), compared with pricing perils such as expropriation and political violence (Ascari, 2010). This is in line with Palmer’s (2009) argument that a problem with the benchmarking approach is that there are not enough adequate benchmarks (e.g., benchmarks that could passably capture expropriation or political violence risks). A second approach to pricing PRI contracts could be referred to as a trial and error method. There are political risks for which there is no historical claims data or benchmarks available. In those circumstances, pricing PRI products appears to be more art than science. Sundberg, et al, (2009) note that the pricing process has traditionally been more of a qualitative task rather than a quantitative task. It has relied on underwriter’s experience and heuristics.

Palmer (2009) takes a sample of 24 public PRI providers and analyses how public mandates affect their pricing strategies. The findings show that the pricing of PRI contracts varies greatly among the public insurers. A number of public PRI providers use OECD country classification as the basis for their pricing model, which is usually applied as a lower price limit (e.g., OEKB, EKN and KEIC), and then there are public providers like MIGA, COSEC and EKF who have their own in-house pricing models.
Other providers, such as OPIC, charge different basic rates for each risk, depending on a sector within which the risk is located (e.g., oil sector vs. manufacturing sector) and then adjusting it for the country risk. This can be illustrated by OPIC’s example rates per US$100 of coverage, which are as follows (see table 2.2):

<table>
<thead>
<tr>
<th>Table 2.2: OPIC premium base rates</th>
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<tbody>
<tr>
<td>Premium rate</td>
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<tr>
<td>(oil and gas)</td>
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<tr>
<td>Inconvertibility</td>
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<tr>
<td>Expropriation</td>
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<tr>
<td>Political Violence</td>
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Source: Overseas Private Investment Corporation 2010

One could argue that MIGA is a leader of the public market in terms of advances in political risk pricing. The Sundberg, et al, (2009) paper gives a detail description of MIGA’s pricing strategy. The multilateral insurer adopts a risk-based modelling approach, which integrates the Economic Capital (EC) and costing models into a single pricing strategy. The cost of capital is charged as part of a premium in order to be consistent with the capital calculated for a portfolio of political risks and allocated to a given project. The EC is a function of a probability distribution of political risk losses. MIGA incorporates OPIC’s published claims history in order to address the need for additional “richness” in the insured losses data, since it does not have an extensive claims history itself. The PRI provider only had three claims during the period 1988-2009 (Nolan, et al, 2011). It is important to stress that MIGA’s convention and stakeholders require that the insurer shall sustain itself financially and pay claims as they arise. They also demand from MIGA to charge adequate rates for its PRI products so to avoid crowding out private insurers. For these reasons it could be argued that MIGA’s pricing model can be adopted by the private sector, as it is too like a private PRI market is required to be self-sufficient.

There is little academic analysis done on the private PRI sector pricing strategies, with an exception of Coppola (2009) and Palmer (2009) who offer some insight into this area of PRI. Coppola (2009) argues that the private sector pricing differs from that of the public sector. Private insurers must price their products in a way that increases shareholder value, whereas in the public sector the main objective might be to provide support to small businesses or promote domestic exports. This in turn has an effect on
risk selection and PRI pricing. For example, a public insurer might be able to provide PRI coverage at a lower rate if it is in line with the home government objectives (e.g., promote diplomatic ties or exports). Palmer (2009), however, disagrees by arguing that the differences between public and private sector pricing models might not be that significant. Even though public sector stakeholders might not anticipate that public PRI insurers will deliver profits, they can require them to price PRI contracts adequately so that burden on a taxpayer is kept to a minimum. For instance, Export Development Canada (EDC) and the Export and Finance Insurance Corporation (EFIC) of Australia are required to be self-sufficient. In other words, they are expected to charge rates sufficient to cover expected losses. Therefore, public PRI providers are faced with dilemma what premium to charge for their products. Premiums cannot be too high as this can undermine the primary objective of public mandate (e.g., to foster exports or contribute to economic development), and they cannot be too low as it can be considered a burden on a taxpayer or result in crowding out private insurers. James (2004) argues that the private PRI market has a similar problem. The insurers have to find a price for their products that is not too high, otherwise a client will find a different way to manage a risk, or not take it at all. Palmer (2009) also acknowledges some differences between public and private insurers. The private sector has a limited country capacity, which contributes to the pricing volatility. Quite often PRI providers receive high demand for PRI coverage in specific countries, which pushes a price up. The biggest difference between private and public sectors is that even when private market has capacity constraints, they tend not to demand higher prices for tight country constraints in comparison with the private market which is likely to push prices up. Public market pricing is much more stable than the private sector (Palmer, 2009).

2.11 Conclusion

This chapter has examined the existing contributions to the study of the PRI sector. The majority of the studies mentioned in the literature review above tend to come from within the industry (see e.g., Hollywood, 1992; West, 1999; Galvao 2001; Martin 2002; Gordon, 2008; Palmer, 2009; Coppola, 2009; Sundberg, et al, 2009; Ascari, 2010). This highlights the need for more independent academic research in order to reduce bias caused by under-reporting (e.g., to draw attention to PRI pricing issues or contracting
difficulties). Moreover, there is a major gap in the existing PRI literature regarding the specifics of political risk underwriting mechanics (i.e., how the private PRI market selects and prices political risks). The following research questions will therefore be addressed in this study:

1. How does the UK PRI market select political risks for a portfolio of risks?
2. What pricing methods does the UK PRI market use?
3. Which factors impact on perceptions of political risk underwriters as to what risks are acceptable?
4. Does the UK PRI market have different levels of political risk acceptance as compared to other PRI markets?
5. Do UK political risk underwriters price political risks differently from underwriters in other markets?

As far as we are aware, there has been no critical analysis done to investigate PRI underwriting practice in the private sector. This thesis will focus on addressing questions concerning political risk selection and pricing in the UK private insurance market.

The following chapter describes the methodology used to address these research questions.
CHAPTER 3: Research Methodology and Methods

3.1 Introduction

Several major gaps have been identified in the literature reviewed in the chapter 2. PRI is a relatively new area of research, with little known about the political risk underwriting practices that take place in this insurance sector. The main objective of this study is to develop a theoretical framework for political risk underwriting in the UK private insurance market. In order to fulfil this aim, the study adopts a mixed methods approach of grounded theory and scenario-based survey. This study breaks new ground in two respects. Firstly, it is a pioneering study of the underwriting decision-making process of the UK PRI market. This research project also compares the UK PRI market with other PRI markets in terms of political risk selection and pricing patterns. A similar comparison is made between the UK PRI market and a control group\(^6\) in order to explore if reasoning is fundamentally different outside the immediate PRI context, which is one of the original contributions. Secondly, the research methods adopted here have never been applied in the PRI field prior to this study. The majority of existing PRI studies are not grounded in empirical evidence or theoretical analysis. The intention of this chapter is to justify and explain the research design of the present study.

The chapter sets out a conceptual framework for the subsequent analysis based on the mixed methods approach, wherein the grounded theory analysis results are used then to help inform a design of the scenario-based survey. The rationale behind the mixed methods approach is not to replace existing research paradigms, but rather to maximise the strengths of both qualitative and quantitative research and minimise the weaknesses of both (Johnson

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\(^6\) Control group participants came from the PRI-related fields such as credit export insurance and political risk consultancy. It was required that they had some knowledge of PRI products in order for the analysis to produce meaningful results (i.e., to see if the PRI-related fields perceive political risks differently from the UK PRI market).
and Onwuegbuzie, 2004). This chapter details the design of the empirical research, including the techniques and methods used for data collection and analysis. It is divided into five sections. The first section outlines the research questions. The second section describes the approaches taken to address the research questions raised. The third section describes how grounded theory techniques have been adopted for the purpose of this study and the rationale behind the research method chosen. The fourth section describes the development of the survey used to examine the underwriting process, which is one of the contributions to the research in this area. Finally, the fifth section concludes the chapter.

The following section outlines the research questions that this study aims to address.

### 3.2 The Research Questions

The purpose of this thesis is to contribute a new body of knowledge to the area of political risk underwriting. There is a lack of understanding as to how this niche market operates, manages and tackles issues arising from the PRI business, such as portfolio management, risk selection, pricing, market competition and sustainability. Thus, the objective is to fill these gaps in the risk and insurance literature by answering the following research questions:

1. How does the UK PRI market select political risks for a portfolio of risks?
2. What pricing methods does the UK PRI market use?
3. Which factors impact on perceptions of political risk underwriters as to what risks are acceptable?
4. Does the UK PRI market have different levels of risk acceptance as compared to other PRI markets?
5. Do UK political risk underwriters price political risks differently from underwriters in other markets?
Research into risk perception and its findings are of interest and relevance to academics and market practitioners alike. There has been a substantial amount of research carried out on risk perception and how it impacts on individual’s decision-making (see e.g., Slovic, Finucane, Peters, and MacGregor, 2004; Lowenstein, Weber, Hsee, and Welch, 2001; Sjoberg, 2000; Folkes, 1988). However, there has been substantially less work done on how insurance experts or scientists perceive certain risks and how their perceptions impact on their professional decision-making. Risk perception affects insurance firms in a number of ways, such as influencing the demand for insurance products, as well as impacting upon insurers’ pricing and risk selection functions both directly and indirectly. Political risk underwriters’ risk perception is not the primary focus of this study, but the research methods employed to address the research questions contribute some insights into the area of risk perception research.

Having identified the research questions of this study, the next section will describe the research approaches taken to deal with these questions.

### 3.3 Approaches Taken to Address the Research Questions Raised

Ontology is concerned with the different views of reality which a researcher holds to exist. Bryman (2001) argues that there are two main ontological positions, that is, objectivism and constructivism. Objectivism believes that reality is real and apprehensive where “social phenomena and their meanings have an existence that is independent of social actors” (Bryman, 2001, p. 17). Constructivism argues the opposite by stating that social reality, social structures as well as individuals are interconnected. In other words, people have an active role to play in constructing social reality, which in turn implies that social reality and its structures are temporary and may transform in response to personal and societal changes (Bryman, 2001). Objectivism and constructivism are simplified versions of social reality and social structures which are rarely observed in their purest nature in practice (Silverman, 2001). In some cases, both schools of thought can offer valuable insights into the research subject.
Epistemology is concerned with knowledge, its validity and its limits (Cope, 2002). The researcher must adopt a methodological research technique in order to understand the world or discover social constructs. The three main epistemologies are positivism, realism and interpretivism. Positivists assume that the researcher is independent from the research object and that the social world can be studied according to the same principles as the natural sciences (Bryman, 2001). This in turn can be related back to the objectivism position. Robson (1993, p.60) argues that a positivism research philosophy does not take into account an individual’s ‘ability to reflect on problem situations’ and in turn to adjust his or hers behaviour or actions. This makes positivism inappropriate for the study of risk perceptions and risk acceptance. Interpretivism takes the opposite position to that of positivism and argues that reality and an individual who studies it are inseparable. One of the major limitations of the interpretivist position is that it fails to acknowledge the factual aspects of business. In other words, it fails to recognise that abstract things such as risk can exist within an external reality independently of the perceptions of any one individual (Magee, 1985). The interpretivist paradigm is not entirely suitable for this study, as it does not allow one to formulate or justify generalizations. Finally, realism implies a belief that reality is ‘real’, but can only be imperfectly and probabilistically apprehensible (Godfrey and Hill, 1995; Guba and Lincoln, 1994; Tsoukas, 1989). Popper (Magee, 1985, p.61) describes realism’s world as a one which is “largely autonomous, though created by us”. This study does not aim to reject the traditional dualisms (e.g., subjectivism vs. objectivism, and positivist vs. interpretivist) or purist positions; rather it seeks to find a workable solution by combining methods and philosophies that offer the best opportunities to answer the research questions. Burke and Onwuegbuzie (2004, p.17) argue that “what is most fundamental is the research question – research methods should follow research questions in a way that offers the best chance to obtain useful answers”. Similarly, Saunders, Lewis and Thornhill (2009) agree that with regard to the design of the study, the research approaches chosen have to be appropriate to the research subject whether the method is qualitative or quantitative.

This study adopts a pragmatic approach which supports mixed methods research. It moves beyond the qualitative versus quantitative research methods debate, by taking the side of researchers that argue that different research questions demand different methods. Both qualitative and quantitative research methods are important. Qualitative research is useful for describing complex phenomena and enabling the generation and collection of rich data,
whereas quantitative research allows for testing and validating the constructed theories about how the phenomena occurs (Onwuegbuzie and Leech, 2004b). Rossman and Wilson (1991) also support linking qualitative and quantitative research methods and argue that the two methods complement each other. The mixed method approach initiates new lines of thinking and in turn leads to analysis that provides richer details. The PRI business and its community is a complex phenomenon which is affected by a number of external and internal forces (e.g., politics, economics, environmental factors, personal preferences and beliefs). PRI could not be fully understood using the purist research position, as it would provide only a limited explanation of the phenomenon. For this same reason, it is believed that the mixed method approach is most suited to answer the research questions and to gain a deeper understanding of the PRI business. The following sections explain in greater detail the qualitative and quantitative methodological methods adopted for this study.

### 3.4 Qualitative Research Design

Qualitative research is well suited to study of the social world that includes meaning, perceptions and assumptions of individuals, groups and organizations (Amaratunga et al., 2002). After an extensive qualitative methodology review, the grounded theory method was chosen in order to answer the following research questions:

1. How does the London PRI market select political risks for a portfolio of risks?
2. What pricing methods does the London PRI market use?

Given that the grounded theory method (GTM) is primarily used for developing theories in situations where little is known, it is important to look at some definitions of a theory first. Kerlinger (1979) gives one of the most comprehensive definitions of a theory, which is still utilized in quantitative and qualitative research today. A theory is “a set of interrelated constructs (variables), definitions, and propositions that present a systematic view of phenomena by specifying relations among variables, with the purpose of explaining natural phenomena” (Kerlinger, 1979:64). Similarly, Strauss and Corbin (1990) argue that a theory
has a number of characteristics so that there is a series of relationships across concepts and sets of concepts, and that these relationships can be traced back to the data. Morse (1994:25-6) extends the definition by proposing that:

“A theory provides the best comprehensive, coherent and simplest model for linking diverse and unrelated facts in a useful and pragmatic way. It is a way of revealing the obvious, the implicit, the unrecognized and the unknown. Theorizing is the process of constructing alternative explanations until the ‘best fit’ that explains the data most simply is obtained. This involves asking questions of the data that will create links to established theory”.

Glaser and Strauss (1967) make a distinction between substantive theory and formal theory. Substantive theory is developed from work in a specific area; for example, a theory offers a possible explanation of a particular type of organization. A substantive theory does not try to generalize and does not have an explanatory power outside of the immediate field of study. In contrast, a formal theory can be applied across a range of situations. For the purpose of this study Strauss and Corbin’s (1994) definition is employed where a theory is a set of relationships that offer plausible explanations of the phenomenon under study.

A brief description of how GTM applies to this study follows.

3.4.1 Grounded Theory Method

The GTM is one of the most well-established qualitative research methods that has been around for more than 40 years (Titscher et al., 2000). The method is essentially a social science approach to theory building and to a lesser extent to providing a fresh angle on existing knowledge. Glaser and Strauss are the original creators of the GTM. Grounded theory was originally developed by sociologists for sociologists, but it is now extensively applied across a range of subjects such as system development, organizational culture, marketing, consumer behaviour and electronic data interchange (Goulding, 2002). This is the first study to adopt the GTM to the PRI subject. Hood (2007, p.154) summarised Glaser and Strauss’s (1967) version of grounded theory in seven statements:
• A spiral of cycles of data collection, coding, analysis, writing, design, theoretical categorization and data collection.

• The constant comparative analysis of cases with each other and to theoretical categories throughout each cycle.

• A theoretical sampling process based upon categories developed from ongoing data analysis.

• The size of a sample is determined by the ‘theoretical saturation’ of categories rather than by the need for demographic ‘representativeness,’ or simply lack of ‘additional information’ from new cases.

• The resulting theory is developed inductively from data rather than tested by data, although the developing theory is continuously refined and checked by data.

• Codes ‘emerge’ from data are not imposed \textit{a priori} upon it.

• The substantive and/or formal theory outlined in the final report takes into account all the variation in the data and conditions associated with these variations. The report is an analytical product rather than a purely descriptive account. Theory development is a goal.

There are a number of variations of grounded theory but most notably two, each associated with one of the original authors Barney Glaser and Anselm Strauss, i.e. “Glaserian” and “Strauss and Corbin” (Rennie, 1998). McCann and Clark (2003) see the variation in the domain of GTM application as a sign of method maturity. Obviously there are differences between variations of GTM, but there are also a number of constants which are used despite the version adopted. These include \textit{theoretical sampling} as contrasted with purposive sampling and \textit{theoretical saturation} which insists that the researcher stays in the work field until no new information emerges from the collected data. The other distinctive
characteristic, which is common across the different versions of GTM, is *constant comparison*. The rationale behind the *constant comparison* of data is to develop concepts and categories; gradually moving from the descriptive level to an abstraction of data and ultimately to higher order theoretical categories, or to one all-inclusive category that forms the basis for the explanation (Hood, 2007). The main difference between the “Glaserian” school and the “Strauss and Corbin” school, according to Goulding (1999), is that Glaser focuses on the interpretive, contextual and emergent nature of theory development, whereas Strauss seems to emphasise complex and systematic coding techniques. The “Strauss and Corbin” approach was chosen for this study.

With regard to choosing a methodology to research the field of PRI, grounded theory was selected after an evaluation of a range of possible research methods. The following key points summarise the rational for choosing the GTM for this study:

- It is a methodology which has theory building as its main aim, rather than theory testing. Given the lack of integrated theory in the risk and literature regarding political risk underwriting, an inductive approach that allows theory to emerge from empirical data seemed the most appropriate.

- It has a set of established guidelines both for conducting research and for interpreting the data. This in turn can offer a sense of security when delving into unknown research territory.

- It is a methodology that encourages creativity and self-development.

- GTM is especially renowned for its application in the study of human behaviour. The human element plays an important role in the PRI business.

- Finally, it is an established and credible methodology which is widely adopted in social science studies. However, it has not been largely employed in the field of
risk and insurance. This in turn provided an opportunity to apply a legitimate methodology to new research field.

The next section describes the qualitative data collection process which was guided by the theoretical sampling principle rather that statistical sampling.

3.4.2 Data Collection

One of the distinct features of grounded theory is theoretical sampling. Glaser and Strauss (1967) argue that it is impossible for a researcher to predetermine the size of a sample for a GT study in advance. Theoretical sampling differs from statistical sampling in that it is directed by theory and not by the size of a population. The theoretical sample needs to be both wide in range of comparison groups and prompted by the emerging theory (Stern, 2007). Glaser and Straus (1967:45, 47) define theoretical sampling as follows:

“Theoretical sampling is a process of data collection for generating theory whereby the analyst jointly collects, codes and analyses his data and decides what data to collect next and where to find them, in order to develop his theory as it emerges. This process of data collection is controlled by the emerging theory... The basic question in theoretical sampling (in either substantive or formal theory) is: what groups or subgroups does one turn to next in data collection? And for what theoretical purpose? In short, how does the sociologist select multiple comparison groups? The possibilities of multiple comparisons are infinite, and so groups must be chosen according to theoretical criteria.”

Similarly, Stern (2007) argues that theoretical sampling should consist of data that will advance the theory. He also states that the sample for GT study needs to be representative but does not need to contain huge amounts of data. Large files are likely to go unanalysed or the researcher can become plagued with the volume of data he or she has to analyse, which in turn can result in fundamental research process mistakes (Glaser, 1998). The rule of thumb is that saturation in the data is reached when the researcher hears nothing new. However, the best explanation of theoretical saturation remains by Glaser and Strauss (1967:61, 63):
“The criterion for judging when to stop sampling the different groups pertinent to a category is the category’s theoretical saturation. Saturation means that no additional data are being found whereby the socialist can develop properties of category. As he sees similar instances repeatedly, the researcher becomes empirically confident that a category is saturated. He goes out of his way to look for groups that stretch diversity of data as far as possible, just to make certain that saturation is based on widest possible range of data on the category ... The adequate theoretical sampling is judged based on how widely and diversely the analyst chose his groups for saturating categories according to the type of theory he wishes to develop.”

Several features distinguish the informants included in this research domain. They were political risk insurance market participants. They all worked in the political risk insurance field, but were from different companies and had different job roles, such as underwriter, broker, political risk analyst and product developer. They also had to be from a range of managerial levels and be at different stages of their career (e.g., senior underwriter vs. junior underwriter) in order to have a wide range of comparison groups (Stern, 2007).

The data collection was carried out during 2009 – 2010 through interviews with PRI providers from the Lloyd’s markets and London Company markets, as well as with two leading political risk broking houses. The names of the companies and participants are kept anonymous due to the competitive and sensitive nature of the PRI market. The UK PRI market is a niche market with the total population of the PRI community (including both PR underwriters and PR brokers) of less than two hundred. Table 3.1 provides a summary of study participants and identifies areas of expertise with some interviewees having expertise on both the political risk underwriting and broking sides. The UK PRI market was selected as the research site for two main reasons: firstly, it has a reputation as a leading PRI market; and secondly, it is one of the largest PRI markets.
Table 3.1: Number of interviews conducted at the London PRI market and the position of the interviewees (during 2009-2010).

<table>
<thead>
<tr>
<th>Participant</th>
<th>Area of expertise</th>
<th>Number of interviews</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participant 1</td>
<td>Underwriter</td>
<td>1</td>
</tr>
<tr>
<td>Participant 2</td>
<td>Underwriter</td>
<td>1</td>
</tr>
<tr>
<td>Participant 3</td>
<td>Junior Underwriter</td>
<td>1</td>
</tr>
<tr>
<td>Participant 4</td>
<td>Risk Analyst</td>
<td>1</td>
</tr>
<tr>
<td>Participant 5</td>
<td>Underwriter</td>
<td>1</td>
</tr>
<tr>
<td>Participant 6</td>
<td>Junior Underwriter</td>
<td>1</td>
</tr>
<tr>
<td>Participant 7</td>
<td>Underwriter</td>
<td>1</td>
</tr>
<tr>
<td>Participant 8</td>
<td>Underwriter</td>
<td>1</td>
</tr>
<tr>
<td>Participant 9</td>
<td>Broker/Product Developer</td>
<td>2</td>
</tr>
<tr>
<td>Participant 10</td>
<td>Underwriter/Broker</td>
<td>1</td>
</tr>
<tr>
<td>Participant 11</td>
<td>Underwriter/Broker</td>
<td>1</td>
</tr>
<tr>
<td>Participant 12</td>
<td>Broker/Underwriter</td>
<td>1</td>
</tr>
<tr>
<td>Participant 13</td>
<td>Underwriter</td>
<td>1</td>
</tr>
</tbody>
</table>

For the purpose of this study, a variety of “engaged” data gathering methods were employed. These involved semi-structured and unstructured interviews that were supplemented with documentation reviews, observations and informal discussions. Fourteen interviews were conducted, each lasting an average of an hour. The sources were not selected randomly and were chosen carefully to ensure that they were true representatives of the research domain. The interviews were focused on understanding the political risk underwriting process through the lenses of both the underwriter and the broker and their perception of the changes in underwriting practices over time. All interviews were recorded, transcribed and subsequently analysed in accordance with the guidelines of grounded theory methodology. Detailed notes were taken during the interviews. In addition, some of the study participants agreed to provide documentation on policy wordings, internal presentations on political risk business and other relevant information that were subsequently included into the data analysis. Observations were carried out in Lloyd’s insurance market where underwriters agreed to be studied while doing business as normal at a Lloyd’s box. Such grounded theory studies are often used in system development, organizational culture, marketing, consumer behaviour and social sciences as a method to explore and understand the research phenomenon within a particular context (Goulding, 1999). The following section describes the data analysis process employed in this study.
3.4.3 Data Analysis

Analysis of the qualitative data involved a number of cycles of data collection, coding, analysis, writing, design, and theoretical categorization. This study took the Corbin and Strauss’s (1990) approach to data analysis. Corbin and Strauss (1990) state that there are three types of coding: open, axial and selective, all of which were utilised in the present study in order to answer the research questions. Open coding involved dividing data into one-sentence segments which were subsequently given conceptual labels. The concepts that emerged from the empirical findings were constantly compared and contrasted. As new data was added and as analysis progressed, some concepts were reorganised under different labels. Corbin and Strauss (1990, p. 13) argue that “open coding and the use it makes of questioning and constant comparison enables investigators to break through subjectivity and bias.” In axial coding, the concepts that emerged were related to their sub-categories (see Table 3.2). These relationships between the concepts and sub-categories were constantly tested and compared against data. Selective coding occurred in the later phase of data analysis. All categories, sub-categories and concepts were unified around three “core” categories, which were labelled: portfolio management, risk selection and pricing (see Chapter 4). These core categories represent the central phenomenon of this study. The resulting theories were developed inductively from data rather than tested by data. In other words, categories and concepts emerged from the data and were not imposed priori upon it. The quality of a developed core category is assessed by the density of its categories, sub-categories and concepts (Corbin and Strauss, 1990). The categories and concepts help to explain the process of political risk underwriting in the UK PRI market. However, it is a pioneering study and no claim is made that the categories and concepts are complete and comprehensive.
Table 3.2: Risk selection in political risk insurance: categories, concepts and field data

<table>
<thead>
<tr>
<th>Sub-categories</th>
<th>Concepts: examples</th>
<th>Field data from interview notes: examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country</td>
<td>Political stability</td>
<td>Participant 5: Whether someone is a dictatorship, or democracy, or a monarchy, has its own dynamics. But from our point of view, the thing we’re looking for is stability. If we know it is bad but it is stably bad we can price it. If it is very volatile that is very difficult.</td>
</tr>
<tr>
<td></td>
<td>Legal environment</td>
<td>Participant 1: What is the legal set-up in the country? How easy is to defend against expropriation? Whether or not they are signed up to ICSID, you know, arbitration and all that kind of thing. Which can be very important and it gives you an idea of the attitude of the country.</td>
</tr>
<tr>
<td></td>
<td>Economic situation</td>
<td>Participant 4: We look at inflation, domestic interest rates. And then the external account - how do they get hard currency, how much do they have? We look at various ratios which show sustainability of the private sector, public sector. Is there currency free floating? Is it open to a speculative attack? Is it pegged? What supports that pegged? That comes with the economics.</td>
</tr>
<tr>
<td>Client</td>
<td>Company financials</td>
<td>Participant 6: So [the] insured are crucial both in terms of their experience and their financial strength. As we talked earlier if they are short of money that limits their options. It means it is harder for them to get out of the trouble or to deal with the problem proactively.</td>
</tr>
<tr>
<td>Tacit knowledge</td>
<td>Intuition</td>
<td>Participant 12: The actual process will vary from syndicate and company. Some people have very structured processes; some tend to do it in a more... It is more of a judgemental way. They have gut feeling or instinct.</td>
</tr>
<tr>
<td></td>
<td>Trust</td>
<td>Participant 13: There is trust. I mean you are underwriting as if you were a bank, a trader but you can’t see everything that your client sees. So there has to be trust between you and your insured and there has to be trust between you and your broker.</td>
</tr>
<tr>
<td></td>
<td>Memorability</td>
<td>Participant 10: You never forget your basics - the world always finds an excuse why he should do something. And that is where you have to be careful. Argentina is a great example. Argentina has gone nowhere in the last 9 years. It hadn’t really dealt with its foreign debt at all. And it dealt with it very badly and yet you have banks flooding in there again doing money. On what basis?</td>
</tr>
<tr>
<td></td>
<td>Heuristics</td>
<td>Participant 3: From the contract frustration risk point of view, you know, not paying on your loan or whatever... Or not meeting oil delivery... Reputation is a massive factor.</td>
</tr>
</tbody>
</table>

3.4.4 Criticism and Limitations of Grounded Theory

Grounded theory as a qualitative research method has an established place in a number of disciplines such as psychology, education, nursing, anthropology, and more recently in...
management, finance and accounting fields (see e.g., Glaser and Strauss, 1967; Schroeder and Congden, 1995; Browning et al., 1995; Hunt and Ropo, 1995; King, 1996; Crook and Kumar, 1998; Parry, 1998; Manning et al., 1998). Regardless of the wide usages of the grounded theory method, there are a number of criticisms and limitations which should be addressed. One of the major difficulties with the GTM is that a researcher has no way of knowing the exact sample size in advance, which makes planning and estimating the cost of research problematic. In addition, even if a grounded theorist uses the method correctly and follows all procedures (e.g., stays in the field until saturation is reached) there is no guarantee that a theory will emerge. This could be due to a lack of researcher’s theoretical sensitivity, expecting too much too soon or rushing the research (Wai-Chung Yeung, 1997).

Other aspects that need to be taken into account are time and space. According to Strauss and Corbin (1994), theory is not the formulation of some discovered elements of pre-existing reality ‘out there’. That view belongs to the positivist researchers. Theories in grounded theory are seen as interpretations made from given perspectives. Thus, it is important to recognise that interpretations are temporally tied. They should always be considered as conditional and subject to future re-evaluation. Validity of interpretations can be limited in time as they may become outdated or in need of qualification, depending on the underlying known and unknown circumstances. Similarly, Brown (1973, p. 8) argues that grounded theorizing methodology is not suited to certain types of research problems:

“[Grounded theory] may only be profitable in a fairly limited range of circumstances. The type of material best given to the development of grounded theory... tends to involve relatively short-term processes, sequences of behaviour that are directly observed or can be easily reported upon, and behaviour which has a repetitive character. Something missed can often be observed again.”

This study avoids some of the criticisms expressed above. The phenomenon of political risk underwriting can be repeatedly observed as PRI, in its simplest form, is generated through repetitive processes where expired risks are replaced by new exposures. Although PRI providers have long-term objectives, their business by its nature is stretched through a

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8 For example, Tillmann and Goddard (2008) adopt GTM approach to investigate how strategic management accounting is perceived and used in practice in a large multinational company in Germany. Their samples consist of 46 formal interviews.
number of short-term periods, i.e. financial years. Hence, the present study meets Brown’s (1973) requirements for it to be suitable for grounded theory analysis.

3.4.5 Reliability and Validity

The quality and credibility of research findings are defined in terms of reliability and validity. Reliability refers to an indication of the stability and consistency of a measuring instrument, in other words, a repeated study has to produce the same findings (Ghauri and Gronhaug, 2010). Validity is “the extent to which the research findings accurately reflect the phenomena under study” (Collins and Hussey, 2009, p.64). There are number of different ways in which the validity of research can be assessed, such as: content validity, predictive validity, concurrent validity, face validity and construct validity. The most common validity utilised in business research is construct validity, which is “the extent to which an operationalization measures the concept which it purports to measure” (Zaltman, Pinson, and Angelmar, 1977, p. 44).

This study took a number of precautionary measures in order to assure the quality and credibility of the research results. To boost the reliability of the GT analysis results, the inter-rater reliability technique was adopted (Jackson, 2011). Inter-rater reliability is a measure of consistency that assesses the agreement between the independent raters (i.e., judges or observers) in relation to the research subject matter. This study asked two independent raters to code and interpret the same interview extracts in order to determine the percentage of agreement between them as well as the researcher. Inter-rater reliability was high (80%), which indicates that the findings of the GT analysis can be, to a large degree, replicated by another researcher. The limiting factor for replication is theoretical sensitivity. Construct validity of the research project was ensured through the use of multiple sources of data. Semi-structured interviews and electronic surveys have enabled the acquisition of multiple perceptions on the single reality of the phenomenon of PRI underwriting. All interviews were recorded and transcribed in order to maintain evidence of raw data and to ensure methodological transparency and reliability. The interview
schedules and survey are, therefore, included in the Appendices (see Appendix C and Appendix D).

The next section will discuss, in more detail, the quantitative research design employed to obtain the data required to answer research questions 3 to 5.

### 3.5 Quantitative Research Design

Quantitative research enables one to make more general statements about a population, as well as to investigate the relationship between variables (Saris and Gallhofer, 2007). There are a number of methodologies associated with quantitative research, such as experimental studies, surveys, cross-sectional studies and longitudinal studies. This study adopts a semi-experimental approach; which is a hybrid between a survey and an experimental study. A survey can be defined as a research instrument, which “entails the collection of data on a number of units and usually at a single junction in time, with a view to collecting systematically a body of quantifiable data in respect to a number of variables which are then examined to discern patterns of association” (Bryman, 1989, p.104). An experimental study attempts to observe the effect of an independent variable on a dependent variable. The independent variable is deliberately manipulated so as to understand the different impacts it can have on another variable. Collis and Hussey (2009) state that experimental studies can be conducted in a systematic way in a natural setting or in a laboratory. A semi-experimental approach was chosen, as it allows the researcher to have more control over certain factors.

The research approach taken in this study allows the analysis of a political risk underwriter’s decision-making in a quantitative manner. In doing so, it also compares a political risk underwriter’s reasoning to that of others indirectly involved in the PRI business (e.g., political risk brokers, insurance professionals and consultants), as well as across sections (e.g., UK political risk underwriters vs. USA political risk underwriters). This phase of the research was less descriptive and a deductive approach was more
appropriate. Hypotheses were developed and then tested using data gathered from a semi-experimental survey (i.e., scenario-based survey) (see Chapter 5). The deductive approach taken allowed the following research questions to be addressed:

3. Which factors impact on perceptions of political risk underwriters as to what risks are acceptable?

4. Does the UK PRI market have different levels of risk acceptance as compared to other PRI markets?

5. Do UK political risk underwriters price political risks differently from underwriters of other markets?

The next section introduces the research instrument which has been developed for the purpose of this study. This, again, is one of the contributions of this study.

3.5.1 Development of a Context-specific Research Instrument

This study developed a scenario-based survey, which was specifically designed to complement the findings of the GT analysis. The survey consisted of four hypothetical risk scenarios followed by four tasks, three of which were compulsory. The structure of this semi-experimental design was based on Rest’s (1979) Defining Issues Test (DIT) research instrument. DIT is a research instrument which generally consists of six dilemmas designed to analyse moral judgements. Each dilemma is followed by 12 items, where study participants have to rate each item in terms of importance, and then to rank the most important of these items in making a decision about what to do in the dilemma. The structure of the DIT was modified and adjusted for the purpose of this study.

The research instrument was divided into four sections (a separate section for each risk scenario), with each section further sub-divided into four parts (for a full copy of the survey see Appendix D). Each section was designed to obtain information regarding political risk
underwriting decision-making. Each section started with a hypothetical risk description with the study participant informed that he or she would need to make an underwriting decision regarding the risk. The hypothetical risk scenarios were developed based on the information gathered in the first phase of research in order to keep the risk scenarios realistic. Additionally, PRI industry professionals were asked to confirm whether they thought the final four risk scenarios were representative of insurance applications that they would receive in the PRI market. This semi-experimental study approach seemed to be most appropriate, as it allowed controlling for more context-specific variables that could impact on an underwriter’s risk perception and risk acceptance. Cavanagh and Fritzsche (1985) argue that the use of scenarios allows the researcher to structure a research question in a manner that reflects the issues that arise when making decisions in a ‘real world’ environment. Having read the hypothetical risk description, each study participant was asked to rate 10 items representing various issues that might be considered in making the political risk underwriting decision in terms of their importance (e.g., very important, important, moderately important, of little importance, or unimportant). The second task was to rank the four most important factors out of the 10 rated items. In the third task the participants were asked to decide whether she/he would accept the risk on the behalf of his or her company. The final section of the survey asked for suggestions as to what would be the appropriate rate for the contract of risk acceptance. Each of the four sections followed the same structure described above. The survey also included a demographic questionnaire, which was added in order to understand the socio-demographics of the sample population.

3.5.2 Dissemination of the Research Instrument

The research instrument was administered to both PRI experts and individuals working in PRI related fields but who had no PRI underwriting experience, during mid-2011, using a combination of random, convenience and snowball techniques. The aim was to get as large a sample as possible by including the UK PRI market participants, experts from other PRI markets (e.g., the US, Canada, Australia), trade credit insurance professionals and political risk consultants. In turn, all study participants were categorised under two labels: PRI
experts and non-PRI experts, in order to control for different effects. This study incorporated three dissemination strategies to generate the sample. Firstly, the research instrument was uploaded on the social media site, LinkedIn and targeted towards the ‘Trade Credit and Political Risk Insurance Professionals’ network. Next, an individual request was sent to 500 random members of the linkedin.com group to take part in the study. The survey was accessible to all members of the group, which had 1062 members in September 2011. Secondly, the survey was distributed to the PRI experts who took part in the first stage of this research and were also asked to forward the research instrument to their colleagues. Thirdly, as the main focus of this study is the UK PRI market, the survey was sent to all 34 London PRI providers as it was within the time and financial budget of the research to complete a census of the entire London PRI market population. The research instrument and its versions were administrated through surveymonkey.com. In order to control for order effects, the research instrument came in two versions: Survey I and Survey II. The only difference between Survey I and Survey II was the order in which the scenarios were presented to participants (See table 3.3).

<table>
<thead>
<tr>
<th>Table 3.3: Versions of the research instrument</th>
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<tbody>
<tr>
<td><strong>SURVEY I</strong></td>
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<tr>
<td>Scenario 1: Iraq short-term public payment</td>
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<tr>
<td>Scenario 2: Indonesia project risk</td>
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<tr>
<td>Scenario 3: Kazakhstan non-payment risk</td>
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<tr>
<td>Scenario 4: Saudi Arabia power project</td>
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<tr>
<td><strong>SURVEY II</strong></td>
</tr>
<tr>
<td>Scenario 1: Indonesia project risk</td>
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<tr>
<td>Scenario 2: Kazakhstan non-payment risk</td>
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<tr>
<td>Scenario 3: Iraq short-term public payment</td>
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<td>Scenario 4: Saudi Arabia power project</td>
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The next section reports the sample size and response rate.

### 3.5.3 Sample Size and Response Rate

The UK PRI community is a small community, with the total number of people directly employed in the PRI business at less than two hundred. There are 34 companies that provide PRI in the UK insurance market, of which 14 are London company markets and the remaining 20 are Lloyd’s syndicates as of 2012 (Gallagher London, 2012). The exact
number of political risk underwriters employed in the London insurance market was not assessable due to the lack of market transparency, but PRI underwriting teams ranged in size from as little as one person to six people underwriting teams. This study surveyed each London PRI provider where 71 individual electronic surveys were sent out. The linkedin.com group of ‘the Trade Credit and Political Risk Insurance Professionals’ had 1062 registered members during the dissemination of the research instrument. A total of 104 usable responses were received representing a response rate of 9.12 per cent, which is an acceptable response rate for an academic study in behavioural science (Baruch, 1999).

3.6 Conclusion

This chapter fulfilled a number of purposes. Firstly, the chapter demonstrates an awareness of philosophical, ontological and methodological traditions. Secondly, the justification for the chosen methodology is provided. A mixed-methods approach of grounded theory and scenario-based survey is adopted for this study. This approach is justified considering the main objective of this study and the nature of the research questions proposed. Finally, the chapter details the procedures followed when gathering and analysing the semi-structured interview data. The findings of grounded theory analysis are presented in chapter 4 and the scenario-based survey results are analysed in chapter 5.
CHAPTER 4: Grounded Theory Analysis Results

4.1 Introduction

This study employs Grounded Theory Methodology (GTM) techniques in constructing the research design and in collecting and analysing the qualitative data as outlined in the chapter 3. Figure 4.1, below, illustrates a flow chart of the categories and concepts that emerged from the grounded theory analysis, with Portfolio Management, Risk Selection and Pricing comprising the core categories. Each category has a number of concepts and, in some cases, sub-concepts. The core categories, their concepts and sub-concepts are interconnected and are in coherence with portfolio objectives and constraints. According to the GT analysis results, portfolio management, risk selection and pricing decisions all have to be in line with portfolio objectives and constraints. The profit objective, stability and survival constraints are overriding criteria for effective political risk underwriting. The categories and concepts arising from the research help to explain the process of political risk underwriting in the UK PRI market. This in turn helps to answer the research questions 1 to 3.

This chapter is organised into three sections. The first section discusses the category of Portfolio Management which outlines how underwriters manage their political risk portfolios. This category has three concepts: Objectives and Constraints, Underwriting Strategy and Portfolio Controls. In addition, each concept within the portfolio management category has a number of sub-concepts which will be discussed in greater detail later in this chapter. The second section details the Risk Selection category, according to which PR underwriters employ risk selection criteria that is a combination of both risk explicit and implicit factors. If a risk is to be accepted for a portfolio of

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8 In order to maintain clarity, only core categories and key concepts were added to figure 4.1. All concepts and their sub-concepts are discussed in detail in the main body of this chapter.
9 Research question 1: How does the UK PRI market select political risks for a portfolio of risks? Research question 2: What pricing methods does the UK PRI market use? Research question 3: Which factors impact on perceptions of political risk underwriters as to what risks are acceptable?
political risks, it has to satisfy both the explicit and implicit risk selection criteria. Finally, the PRI *Pricing* category concludes the qualitative results chapter, with the section discussing the three approaches to pricing (i.e., financial economic, rational and combined methods) that exist in the UK PRI market.

**Figure 4.1:** Political risk underwriting: core categories and concepts

4.2 Portfolio Management

*Portfolio Management* is the first category that emerged from the GT analysis. Portfolio management is a dynamic process with new risks continually accepted into the portfolio and old ones expiring during the normal course of business. A political risk underwriter is, essentially, a portfolio manager who assesses risks for possible inclusion in a
portfolio, prices them accordingly and monitors their performance within a portfolio of risks. As one political risk underwriter explained:

Participant 1: *Any company has a portfolio of risks. It has industries that it likes and industries it doesn’t like in given regions or given countries. So there is an existing portfolio of exposures which you need to bear in mind before you take on any new exposure. So, you know, it is not just “here is the risk - shall we do it or not?” You need to look at it in the context of what you already have. How much exposure you already have in that country, on that industry, on that insured?*

Data analysis shows that the process of building a political risk portfolio will have both scientific and judgemental elements. The portfolio management category has three concepts, which are: *Portfolio Objectives and Constraints, Underwriting Strategy, and Portfolio Controls* (see Figure 4.2). Each concept has a number of sub-concepts that are outlined in detail in the next sections.

**Figure 4.2: Political risk portfolio management**
4.2.1 Portfolio Objectives and Constraints

The Portfolio Management concept starts with the set of objectives and constraints which are common practice among different classes of business. From the interview data analysis, it is apparent that political risk underwriters are guided by a number of repeatedly emphasised objectives and constraints. Overall, a profit objective, meaning the delivery of a required rate of return on the capital employed, was highlighted by all study interviewees. Political risk underwriting decisions were also restrained by portfolio constraints, which can be categorised as managerial constraints and statutory constraints. The board of directors and/or management will communicate the objectives and constraints to the political risk department, while statutory constraints are generally more indirect and applicable at a company level, with their effects being indirectly distributed among individual portfolios. The following sections discuss each sub-concept of portfolio management in detail.

4.2.1.1 Profit Objective

Political risk underwriters are responsible for allocating capacity as to what risks are to be accepted and under what terms and conditions. A profit objective appears to be pivotal in helping underwriters to value alternative choices in building a portfolio. The objective can also be interpreted as a relationship between risk and return, which is one of the key concepts in the finance discipline (Watson and Head, 2000). All respondents stressed that profit objective plays an important role, directly or indirectly, in the portfolio management process, which again leads back to the fundamental finance rule of maximising the shareholders’ value. The following extracts from research interviews illustrate this point:

Participant 2: **Fundamentally, political risk insurance is no different than any other type of insurance. It is a commercial insurance line that is written in a private sector. It’s written for profit.**

Participant 11: **We are only just one team with one purpose, which is basically how much money does our product line make.**

Participant 13: **And not necessarily, because there is something wrong with the risk, but, you know, just the return is not worthy really. So it does not mean that it is bad risk, but just wrong for our portfolio.**
Political risk insurance, where written in the private market, is a commercial class of business with underwriters being responsible for portfolio management. It could be argued that political risk underwriters to an extent act as financial managers on the company’s behalf. Their overriding role is to maximise shareholders’ value, while at the same time remaining accountable to their policyholders. Data reveals that a number of underwriters benchmark against the cost of capital, which is the rate of return required by their capital providers, in order to establish acceptable levels of risk-return trade-offs. As one participant said:

Participant 4: *That is the idea. And in the ideal world we think that would give us, you know, the right spread of risk so that we are getting the right return for our capital, our shareholders’ money.*

In order to meet the profit objective, an underwriter has to select a book of business that will produce a desirable loss ratio which is central to an insurer’s performance. There may have been other portfolio management objectives at play but they were not included in the results analysis as they were PRI provider-specific rather than general to the PRI market.

4.2.1.2 Managerial Constraints

Managerial constraints are imposed by the managerial policy and the shareholders’ requirements. For the purpose of this study, shareholders’ constraints are included with managerial constraints under the assumption that managers act in their shareholders’ best interests. Two main requirements that emerged from the grounded theory analysis are survival and stability constraints. This finding supports Stone’s (1973) theory of capacity, which applies profit maximization and survival and stability constraints to model catastrophe risk underwriting and risk selection process.

*Survival Constraint*

The survival constraint includes the overall requirements to limit the risk of insolvency and to make sure that new premium income and capital funds are adequate to meet the liabilities when they fall due. PRI policies are generally 3 to 7 year-long contracts. Once
the policy is issued, a part of the insurer’s capital is committed until the premium is earned. The underwriter’s role is to secure a probability of losses and expenses in a given time period not exceeding the total of capital funds and premium income. The following extracts mimic the survival constraint:

Participant 2: *It [PRI book of business] is written on the basis that it is going be sustainable, long-term life. You know, it is a portfolio. You write a book of business. Like any other underwriter... A key thing to remember is that underwriting is about medium-term, long-term.*

Participant 7: *The detail, the paper work, is a boring bit, I admit. But actually, unless you get that bit right you’ll end up with not just claims – claims, as insurer, are why we are here - but you’ll end up with a really nasty surprise with a claim bigger than you expected. Which for me is an unpleasant conversation with the guy who runs the company and then all my desk is put in a box and I have to go home.*

Political risk is difficult to measure using actuarial methods, i.e., the required degree of accuracy could not be provided by combining the probability distributions of individual political risks within the portfolio. This is partly due the fact that no two risks are identical in the political risk insurance business, and that the volume of business is significantly lower compared with other insurance business lines. As a result, PRI providers are not able to benefit from the law of large numbers when assessing the probability of a loss, as compared with property or motor insurers. Data analysis suggests that the majority of PRI underwriters use an aggregation system to help them set survival constraint parameters.

**Stability Constraint**

The stability constraint is the second major managerial constraint that emerged from the grounded theory analysis. This constraint was originally coded under a portfolio balance objective, but was later recoded under a stability constraint after consulting with existing literature (Stone, 1973a, 1973b). The stability constraint was highlighted by the majority of study participants. The PRI market refers to it as the process of portfolio balancing, which can be described as portfolio diversification and the spreading of risks. This goes back to Markowitz’s (1952) theory of portfolio selection, which shows how an investor can reduce the risk of portfolio returns by choosing investments that do not
move exactly together. Traditionally, political risk insurance is used to manage government risks in developing and emerging markets. There are a limited number of markets that need PRI coverage, which in turn restricts an underwriter’s ability to diversify his book of business. Political risk by nature is a catastrophe risk that can produce very volatile underwriting results, and if a portfolio of political risk is poorly diversified, can threaten an insurer’s solvency position. The specialist political risk broker addressed the issue as follows:

Participant 9: There is a fundamental problem of imbalance of demand in the PRI market: there is too much demand for capacity in countries like Russia, Turkey, and China, where the market participants often have to turn away good, well-priced business because they are at or close to their country limits, and where further exposure would unbalance their portfolio. Nor could you really set up a specialist insurer or reinsurer just to write business in those capacity constrained countries because that (re)insurer would then itself have a very unbalanced book. It is quite difficult to organise an unbalanced world into a balanced insurance book.

A political risk underwriter’s role here is to make sure that a portfolio of risks is well diversified and that a wide spread of business is achieved. In order to diversify a portfolio of political risks and reduce the risk of returns, a PR underwriter has to select risks from different host countries, sectors, etc. As one study respondent explained:

Participant 11: That is definitely something that we monitor and keep an eye on. Once you get down to the country level, first you are checking your diversification geographically anyway, and by type of credit rating and the rest of it. But equally, once you get into the country, you do want a mix of private sector and public possibly... You want all of that if you are in the more developed emerging markets. Because you can get this, you know, they are broader and deeper markets, so the opportunities are there through FDI and through credit. Whereas down the smaller emerging markets and more frontier markets you’re basically only going to get government’s credit risk or some mining operations in terms of expropriations or lenders. It is a much narrower field, and you are going to be concentrated, and you’re probably end up taking only one or two exposures in that country.

These findings are in line with the general insurance and finance literature. According to Huebner et al (1984, p. 560) there are three primary purposes of underwriting: (1) to secure a safe distribution of risks, (2) to secure a profitable distribution of risks and (3) to maintain equity among individual policyholders. Similarly, Strong (1993) argues that portfolio management should be primarily concerned with generating capital and
income growth as well as providing stability of income. From the data analysis, it can be concluded that one of the roles of a political underwriter is to distribute the capacity across available liabilities with the overall objective of providing returns that are in line with portfolio managerial constraints and objectives.

4.2.1.2 Statutory constraints

Statutory constraints were not as directly expressed by interviewees as profit objective and managerial constraints. Rather they manifest themselves in the shape of real, or notional, limits on risk-taking and allocated capacity. Consider the following:

Participant 10: *We monitor everything. All the aggregates for the whole company. So the modelist can make sure that we are comfortable with the risk...*

Participant 11: *I have people to whom I report in terms of business and how much money we are making or losing, and expense control etc. etc. So the president of Global Markets is the person I would report to. And then from the risk perspective we report our numbers to something called Enterprise Risk Management, ERM. So again, Steve really is our contact with ERM and so from all the risks that we accumulated, or aggregates, we report those numbers on a quarterly basis to ERM.*

Insurance companies are regulated by both insurance law and company law, the relevant Acts being the Companies Act 2006, Insurance Companies Act 1995 and Solvency I which will be fully replaced by Solvency II. Insurance companies are expected to adopt the Solvency II capital requirements and risk management standards by 2014. The new European insurance solvency regulation regime is principle-based and risk-sensitive, with the primary objective to more closely align capital requirements with the risk profile of a company. During the course of data collection, it became apparent that political risk underwriters were moving towards a more transparent and risk-based approach to managing their business. Consider the following:

Participant 4: *One of the things that Julian asked me when I first arrived is to set up own country rating models, set up systems that would give pre-approved limits, credit limits. All kinds of stuff that bankers would be used to doing. So I hired a young lady who is doing a PhD in the LSE to help me to design and develop the model.*
Regarding the insurer’s solvency, regulation requires an overall insurance business to maintain adequate Solvency Capital Requirement (SCR) and Minimum Capital Requirement (MCR) (Doff, 2008). These two measures are regarded as reference points against which the company’s excess of assets over liabilities is weighted. The statutory directives do not apply directly to individual portfolios, but their effects are indirectly distributed among them. From the data analysis it appears that the influence of statutory constraints on individual portfolios seems to interact and/or overlap with those constraints set by management. This is probably one of the reasons why statutory constraints were not as explicitly articulated by study participants as the managerial constraints.

4.2.2 Underwriting Strategy

The second concept under the core category of portfolio management is an underwriting strategy. The data reveals that a number of factors influence the portfolio construction, which collectively constitutes an underwriting strategy. The factors discussed in this section emerged from the grounded theory analysis which had not been carried out in the area of political risk insurance (PRI) prior to this study. These factors might not be the only factors that influence the underwriting strategy, but they are the key factors in establishing standards, rules and procedures for accepting, or rejecting, risks offered and for building a portfolio of political risks. A PR underwriting strategy is driven by both internal factors (e.g., risk appetite, capacity, and clientele) and external factors (e.g., reinsurance availability, underwriting cycle and the level of competition) (see Figure 4.3). The internal and external drivers of an underwriting strategy are interconnected with the strength of individual factors varying from one insurer to the next.

Generally, an underwriter is presented with the opportunity set of risks in an underwriting room by visiting brokers. It is the underwriter’s responsibility to accept or decline these individual risks. An underwriting strategy provides guidelines to the underwriter in relation to risk selection and portfolio construction. Data analysis shows that PR providers apply well-defined underwriting strategies in order to meet portfolio objectives such as a profit objective, as well as to comply with the portfolio constraints.
In other words, the underwriting strategy directly feeds into the managerial and statutory objectives and constraints. The strategy, as used by the study participants, can be defined as the opportunity set of acceptable risks from which the portfolio of political risks can be constructed. The following parts of this section discuss each sub-concept of the underwriting strategy in detail.

Figure 4.3: Flow chart of underwriting strategy concept

4.2.2.1 Risk Appetite

A number of study participants addressed risk appetite as one of the key factors guiding their decisions on both portfolio and risk levels. The Society of Actuaries (2006) defines the term as a level of aggregate risk that an insurer can assume and successfully manage over an extended period of time. The data analysis shows that risk appetite reflects an underwriters’ willingness to take on risks and, as such, it depends on insurers’ attitudes to certain types of risks as well as to the size of other risks already held within their PR portfolios. Gai and Vause (2005) argue that risk aversion does not change significantly over time as it is an integral part of an investor’s character, in contrast with risk appetite which can shift notably as a result of financial distress, macroeconomic or political uncertainty etc. Risk aversion and risk appetite are investor attributes; however, risk appetite is more fluid (i.e. it can be affected by external conditions), whereas risk
aversion is more of an inbuilt trait (e.g., an investor is either a risk seeker or is risk-averse). This analogy can be used to explain changes in underwriters’ risk appetite for particular political risks; for example, there was a noticeable fall in the supply of PRI for Asian exposures subsequent to the Asian crisis. A shift in risk appetite can occur due to a real or perceived increase in political turmoil and/or macroeconomic uncertainty in a given region or country. On the whole, there are a number of ways PR underwriters appraise risk appetite. Consider the following examples:

Participant 3: *Maybe that is a size of an overall transaction... Occupancy... For some people, they don’t want to be a part of a market loss. So is it a market loss or is it their loss? For some people that might be the coverage that they are looking at. What sort of form it is. But in reality, for most people, you set these appetites, these different drivers, on your graphics for each portfolio and for each risk [refers to his drawing]. And as I mentioned in the beginning, the hardest thing is not writing a risk, it is writing a portfolio.*

Participant 8: *Basically, if you have a client who wants say $200 million cover. We may prefer - depending on the location and risk appetite for the risk - we could either do that as a straight $200 million or we can price it $100 million and $100 million excess. And we, typically, prefer sit excess. We are trying to structure our position that way.*

Risk appetite can be defined in both quantitative and qualitative terms. As can be seen from the extracts above, PR underwriters set their risk appetites using numerical methods and subjective preferences. For example, PR insurers use an aggregate level of risks to indicate their risk appetite in monetary terms. As one PR underwriter explained:

Participant 10: *So we are sub-divided all the way down. When you look at the risk you work all the way up to make sure you got all the aggregates available on every level.*

A PRI provider sets its risk appetite on every level, within the portfolio of risks, in monetary terms indicating the maximum sum it wants to write on any one individual risk, sector, country, etc. If an application for insurance surpasses one of the aggregate levels set by an insurer, the risk is said to be unacceptable for the portfolio of risks as it exceeds the insurer’s risk appetite. Furthermore, Kirkpatrick (2009) argues that if an enterprise is to be successful with its risk management strategy, risks taken by the entity have to be aligned with both its risk appetite and its risk tolerance. This is particularly the case for financial service companies as the disconnect between risk appetite and risk
tolerance can result in financial distress and subsequent insolvency, as was seen in the 2007 credit crisis.

A PRI provider can also communicate its risk appetite in terms of preferences for particular types of exposures. In other words, it establishes preferences in terms of what types of risks are acceptable and unacceptable for its book of business. For example, the majority of study participants said that they would not be willing to underwrite the Power Purchases Agreements (PPA). Consider the following:

Participant 2: *Well, the number one thing that we do not write, and I think most people don’t write now, is power purchase agreements, PPAs. The power sector obviously went through the 90s where it got killed. Essentially, what happened was people were buying expropriation policies almost as contingent guarantee sitting behind PPA. Sometimes even with the government guarantee in there as well. I wrote a number of those and not all of them went very well...*

A PR insurer can choose what types of risks it wants to insure (e.g., expropriation, government non-payment, etc.) and where it wants its exposure to be (e.g., it does not accept any risks located in Venezuela). Insurer’s preferences can be either explicitly communicated to the PR underwriting team in an underwriting policy or shared with them informally. It is important to set the desired levels of risk-taking in both quantitative and qualitative terms, as an unintentionally constructed “over-risky” portfolio can result in an insurer’s insolvency. Data shows that PR insurers align their risk appetite with their underwriting strategy. Risk appetite, generally, is set at a board of director level and is used as a reference point in day-to-day underwriting activities. Decisions affecting the risk profile of a PRI provider’s business are made daily and an underwriter’s role is to make sure that those are in line with the portfolio objectives and constraints.

### 4.2.2.2 Capacity

*Capacity* is the second sub-concept of the underwriting strategy, which arose in a number of contexts with both the PR underwriters and PR brokers. Capacity plays an important role in the development of the underwriting strategy, risk selection and pricing issues. According to study participants, it also has an impact on the development
of the PRI market. Stone (1972) defines capacity as the amount of capital that an underwriter can commit to insuring a portfolio of risks. Similarly, data analysis suggests that underwriters perceive their capacity in terms of capital and risk-reward relationship. This can be summarised in a PR underwriter’s words:

Participant 11: *Every time I commit, you know, a dollar of my company’s capital, it is a dollar we can lose.*

However, there is no universal definition and measurement of an insurer’s capacity. Doherty (1980) argues that insurer’s capacity is determined by three factors: reserve funds generated by the insurance operation, the law of large numbers and the probability of ruin. Whilst the concept of ruin is unquestionably important in the PRI market, there is no approved method for calculating the probability of ruin for political risks. In addition, the law of large numbers is not as effective in the PRI, due to the relatively low turnover of risks as compared with more traditional insurance markets (e.g., property and liability). Hence, political risk underwriters are limited in their ability to quantify portfolio capacity with any degree of accuracy. Consequently, it creates the danger of risk-taking and the inability to identify spare capacity on the portfolio, which in turn can cause inefficient business operations. In order to avoid the probability of constructing an “over-risky” portfolio, underwriters can set the maximum amount of business that may be accepted at a level equivalent to the overall premium income limit (Bennett, 2004).

No matter how large a PRI provider is, its capacity is going be limited. An insurer has to develop an underwriting strategy so that capacity is used in the most efficient and effective manner. According to the data analysis, an underwriting strategy will determine when an insurer’s capacity will be released, as well as for what types and sizes of risks. As one underwriter explained:

Participant 13: *And sometimes we take views on deals. Where we know there is not much liquidity for a deal. If we think it is not an acceptable deal. It is the time when you release your capacity for that deal, whatever you are willing to give the commitment for deals. Whatever, you want hold back. You know, sometimes we release $5million now on this deal, but then we hold back because I reckon, you know, we probably could get more. Again it is all about strategy. That is the fun but it is very market-oriented. You know, it is how you play. It is a tactic how you play in your market.*
The underwriter will construct his or her portfolio by selecting risks from the opportunity set of risks presented by the political risk brokers. The level of available insurance capacity determines which risks are being selected for the portfolio and under what terms and conditions. This in turn forms the profile of the portfolio. Capacity is a crucial part in the development of an underwriting strategy, as depending on its size, it determines and/or constrains the opportunity set from which the portfolio can be chosen. Consider the following:

Participant 3: *We only write a small line. Our maximum line is £5m on PR stuff. There are some huge lines out there, £100m lines… Lloyd’s market is a huge line. But, you know, they have reinsurance and they’ve got an outlook… So they can say we’re going get that much of premiums, therefore… <...> And brokers like us form the point of view that we can top up line for the syndicated insurance. So if they are trying to place £8 billion and they have £7.95 billion and they really cannot find anyone else, they know there are us. And for the right risk we can do it.*

Stone’s (1972) theory of capacity can be used to explain the process of development of political risk underwriting strategies. Overall, the data analysis shows that underwriters try to allocate their capacity in the most efficient and effective way in order to achieve their goal of profit maximisation within the constraints of tolerable risk and stability of returns.

4.2.2.3 Clientele

Clientele is the third internal driver in underwriting strategy development. Research results demonstrate that PRI providers study their market in order to strategically place themselves within it. In other words, they know who are buying their products as well as knowing who their competitors are. PRI clientele, as defined by the study participants, are as follows:

Participant 4: *I would say nowadays banks make up a large half, over the last few years a large proportion of the demand. And then you got broadly exporters, contractors... Interestingly, multinationals have become less and less involved with us.*

Participant 5: *Banks, manufactures, miners, oil companies, contractors, traders who have stocks or equipment sitting around the world, power companies. But we*
don’t really like power companies’ risk to be honest. So ya traders, bankers... But real world investors rather than portfolio investors.

Insurers demonstrate an insight into the demand side of the PRI products. A diligent underwriter has to understand the products he or she is providing to a client, as well as the drivers that influence the demand. This is important for two reasons. Firstly, it allows a PRI provider to better adapt to the needs of its clients and, as a result, is able to provide better protection for the clients. Secondly, adverse selection problem becomes more manageable when the underwriter understands the motivations behind the purchase of PRI products. Consider the following:

Participant 2: You know if somebody is buying in Angola - I know why they’re buying. Well Angola is not that scary, it is reasonably scary, but certainly not to bankers more to Americans... But, if somebody brings me that fishing vessel risk in the States and we get a few of those through the year that makes me almost naturally uncomfortable... Why are they buying it?

Participant 4: Most business was driven by exporters and contractors, whereas today a lot of business is driven by the financial institutions. Drivers for risk transfer are somewhat different. They are with capital adequacy ratios, country capacity and so on...

Participant 7: And I guess the other reason is corporate governance. Some companies feel they have a duty of care to their shareholders. They might have directors and officers’ obligations. I guess those are the three things that are really driving demand for our products

Underwriters might have a preference or limit the maximum amount of business accepted from particular type of insureds (e.g., bankers, multinationals, contractors, etc.). Also, by studying the reasons for buying behind insurance applications, an underwriter can make a more informed underwriting decision. To sum up, risk appetite, capacity and clientele are internal factors of an underwriting strategy that have an impact on underwriter’s decisions. The following three sections discuss the external drivers of underwriting strategy.

4.2.2.4 Reinsurance program

From data analysis it is apparent that the reinsurance program has an impact on the underwriting strategy. In PRI, as in other business lines, an underwriter has to decide
whether to accept a risk fully or only a part of the risk, and simultaneously decide on the level of reinsurance. The capacity of an insurer will depend upon the availability of reinsurance (Cummins, 2000). An underwriter also needs to consider which type of reinsurance is most appropriate, if at all, for his or her portfolio and/or individual risks. As one study participant said:

Participant 11: You are writing from your own balance sheet. Ya it depends how you buy your reinsurance. Some people buy their reinsurance on what we call quota share basis, which is almost like you go to reinsurer and they blindly follow you. It is almost like you have a shareholder who is providing the capital. Now we buy on that basis. And every year we go back to our reinsurers and they renew their contracts. But the contracts can be for 10 years, but we do it on a yearly basis. So that is fairly stable if you are good. It is a stable way to buy your reinsurance. Others buy what we call excess of loss reinsurance and that is much more - how much capacity, what price? It is much more the market game. And that market is much more unstable. And I think today, obviously, that market is going be fairly highly priced because of the amount of losses in the emerging markets. So it will be interesting.

An insurer benefits from a reinsurance programme in a number of ways, however the advantages have to be weighed against tangible and intangible costs, such as the price of reinsurance and any attached restrictions. The main reasons for buying political risk reinsurance are no different to those of other business lines. Huebner et al (1984) argue that there are three main reasons for reinsurance which are as follows: stability (the technical function), marketing and financial capacity. Hansell (1996) adds a few more reasons to the list, which are catastrophe risk management, consultation, i.e. an aim to get reinsurer’s expertise and advice on highly technical and unusual risk, and corporate strategy. This is consistent with Outreville (2002). As the interview data analysis highlighted, the main rationale for reinsurance are stability and financial capacity. The corporate governance motive was also mentioned but did not appear as a dominant factor. The reinsurance programme increases capacity, which in turn enables PRI providers to accept larger risks that would otherwise be declined or only a small part of risk would be accepted. Political risk reinsurance also ensures greater stabilization of results. This has a substantial effect on underwriting strategy and on the net financial position of a PR insurer. The purpose of underwriting strategy is to achieve the objectives and to ensure that the portfolio constraints are not violated. Reinsurance helps to meet these goals. This again feeds back into the first section on portfolio objectives and constraints.
However, a number of study participants said that they did not have a reinsurance programme. This could be due to the following reasons. Firstly, the availability of political risk reinsurance is limited; same as the primary PRI market, the political risk reinsurance market is a niche and specialized market with even smaller number of providers. Thus, political risk reinsurers are very selective as there are only limited possibilities for diversification. This in turn translates into a shortage of reinsurance supply, which results in high reinsurance prices. Secondly, a number of study participants expressed that a reinsurer can have an overriding say on what is acceptable for the portfolio and/or individual risks. The relative restrictions imposed by the reinsurer can be in disagreement with the insurer’s objectives and appetite for certain types of risks. This, along with the cost of coverage, can undermine the insurer’s demand for reinsurance. Consider the following:

Participant 1: *I think probably it is quite restrictive in terms of what kind of risk you can write seems to me [refers to a reinsurance programme]. You know, the people who do write with the reinsurance programme seem to have, seem to write a very different kind of risks than the ones we write. I suspect it would be expensive, it would be... There would not be much reinsurance market for what we do, because not many people do it. The kind of reinsurance that would be a value to us.*

The availability of reinsurance also, arguably, has an impact on PRI market dynamics. It is common practice for a number of PRI providers participate to on a single risk. By nature political risks are large and complex, with the magnitude of a total loss possibility presenting undue strain on the insurer’s resources. Therefore, an underwriter might be able to accept only a part of the risk and this in turn gives rise to co-insurance by more than one insurer. However, it is also likely that the political risk reinsurance capacity shortage forces insurers to cooperate on some risks which otherwise could be managed by the single insurer. Co-insurance ensures that stability and survival constraints are not being violated, which is similar to the reinsurance function/purpose. This is consistent with Stone’s (1973) stability-survival model.

4.2.2.5 *Underwriting cycle*

Insurance profitability can be plotted on a graph showing a cyclical variation with underwriting standards moving from soft market to hard market and back to soft market
conditions. In the political risk market, the underwriting cycle is considerably more volatile and less predictable than property-liability insurance cycles. As one underwriter said:

Participant 3: *What typically tends to happen, from my experience, you have periods where you make money. Underwriters get over-excited and start thinking that it is free money. Their management tells them to write lots and lots of it and don’t worry about it. So they write lots of it and there is whole lot of losses, because everybody has basically forgotten everything they’ve learned 10 years ago. So they lose a lot of money, then a lot of people come out. The prices start rising again and after some time they kinda start thinking the same thoughts again. And we’ve just seen that. So you do have that cyclical nature of the risk appetite.*

Data suggests that underwriters adjust their strategy according to a phase of the underwriting cycle of the PRI market. The scenario is such that when the market perceives political risk rising, underwriters tighten their underwriting standards, usually by adopting “pull back” tactics. Consider the following:

Participant 7: *There is a natural consequence in insurance industry... A big event happens and insurers tend to run for the hills. “Kinda - oh no I’m not getting involved in that” or waiting to see what happens... Actually there are some fantastic opportunities for people who want to take risks when something like that happens.*

Participant 4: *So then we adjust our pricing on expropriatory risk, we become much more conservative about writing that type of risk in Africa and Latin America and some other countries... So the profile changes slightly.*

Such conditional reflex significantly reduces the available capacity in the market. The underwriting strategy is continually readjusted to reflect market economic, social and political factors. This finding could be used as evidence to support Stewart’s (1984) and Bloom’s (1987) informal capacity constraint models. They argue that the underwriting cycle is primarily caused by a "lack of capacity" in the insurance market. Both models explain the underwriting cycle as caused by the shifts in insurance supply curves. While the market supply curve, as well as individual supply curves, are mainly influenced by net worth, Stewart (1984) and Bloom (1987) also rely on insurer “perceptions,” “attitudes,” and “expectations,” to explain the timing and length of the high-price phase. Similarly, Winter (1988, 1989) and Gron (1989, 1990) argue that insurers hold net worth in order to keep the probability of bankruptcy low and to maintain the ability of insurers to meet claims made by policyholders. Doherty, Lamm-Tennant and Starks
(2003) test capacity constraint, post-loss investment and implicit insurance contract models and conclude that firms suffering the lowest losses, with less leverage would be best able to exploit the post-loss hard market. This was evident in the insurance market following the 9/11 attack, where a number of new firms emerged (i.e. AXIS CAPITAL) and existing ones established their market position as terrorism insurance market leaders (i.e. HISCOX, AIG, ACE). The data suggests that the PRI market is less opportunistic when underwriting conditions worsen and that underwriters are more inclined to pull back. This could be due to the fact that insurance contracts tend to be medium to long-term commitments. It takes longer to readjust underwriting positions when faced with the possibility of a catastrophic loss which in turn, if it happens, prolongs the recovery. As behavioural finance theory (Kahneman and Tversky, 1979) can be used to explain stock price bubbles; the collective perceptions and attitudes of PR underwriters can be employed to explain some aspects of the underwriting cycle development in the PRI market.

4.2.2.6 Competition

PRI providers analyse the nature of the competition in their market. Companies are generally trying to gather the following information: who are their competitors? What products do they offer and at what price? What is their market share and/or line size? And what are they doing that is different or new? Companies then try to position themselves in the market where they can compete in the most beneficial and effective manner. Competition in the political risk market can range from low to relatively high. The level of competition depends on a number of company-specific factors, as well as on external factors such as the risk parameters, e.g. is it a capacity risk, tenor, what kind of coverage. Consider the following:

Participant 13: Well ya there is lots of competition. There are lots of entities. A number of companies are doing this business. Fortunately, there are enough people doing different things. So there is definably a market place. We don’t do short-term business, trade credit stuff. We don’t do short-term quality business where lots of underwriters have to do that sort of business. We are very clear what we want to do and there are not that many people in that space.

Participant 5: Obviously when things get riskier the supply drops. So, actually, the way we prefer and have better results from the risk spectrum is that from the middle. Because you can have a proper conversation with the client about the
structure, coverage... And you tend to be... You are explicitly pricing for very explicit risk. Whereas in the middle everybody wants a piece! It’s just, you write a bit here and a bit there.

In health insurance, for example, the underwriters’ behaviour as described in the above extract could be described as ‘cream-skimming’, where providers systematically try to select those customers expected to be profitable, i.e. belonging to a category of low risk which in turn creates the problem of patient dumping (Barros, 2003). Depending on a number of factors such as portfolio objectives, risk appetite and capacity, a political risk underwriter has to decide whether it is cost-effective to compete for a “popular risk”.

A number of study respondents articulated that competition is mainly capacity-driven. In other words, when there is a capacity surplus in the market competition among PRI providers becomes more intense. The opposite holds true; when there is a capacity shortage, the environment turns less competitive. This becomes apparent when the market is offered a capacity risk. According to Stone (1973), a capacity risk is a risk that requires an underwriter to commit additional capital to insure it within stability and survival constraints. Consider the following:

Participant 13: We all have a different opinion of what we want to do or how to do it. If it is a very popular risk, then yes, it could be very competitive. It does operate as a proper insurance market. But like any other market becomes more or less competitive, depending on how much capacity there is.

Participant 11: I think it is less competitive compared with other business lines. Just because there is less capacity in the market. It is all capacity-driven.

Political risk insurers can and do co-insure with one or more insurers for their own benefit and the benefit of the client. This tends to happen when the market is trying to place a large and complex risk. However, not all PRI providers are willing to co-insure or syndicate a risk. PRI providers take competition into account when developing their underwriting strategies, which helps insurers position themselves within the market. This is in line with Huebner et al (1984), who argue that competition plays an important role in the day-to-day decisions made by underwriters. Overall, underwriting strategy is influenced by both internal drivers (i.e., risk appetite, capacity and clientele) and external drivers (i.e., reinsurance programme, underwriting cycle and competition).
following section outlines the last concept of portfolio controls of the portfolio management category.

### 4.2.3 Portfolio Controls

The third concept in the political risk portfolio management category is *Portfolio Controls*. The portfolio controls concept links back to the portfolio objectives and constraints, as well as directly influencing the underwriting strategy. From the data analysis, it is apparent that underwriters have scientific/quantitative methods in place for controlling and measuring the riskiness of their portfolios. The three most cited techniques for controlling portfolio performance, as identified by the study participants, are: limits (e.g., country limits and sector limits), aggregation and realistic disaster scenarios. Dong and Grossi (2005) suggest similar techniques for managing books of business that are exposed to natural catastrophes such as hurricanes, earthquakes, etc. In addition, this concept also outlines how PRI providers monitor the performance of their portfolios, which in turn encourages diligent underwriting.

#### 4.2.3.1 Limits

A PRI provider is in the business of assuming political risks from businesses. In its simplest form, an underwriter’s responsibility is to understand and evaluate risks, and to assume and price them on insurer’s behalf. Data analysis shows that most PRI underwriting teams cooperate with internal risk management departments or with Enterprise Risk Management (ERM). Some PRI underwriting teams have their own risk analysts who work closely with underwriters in order to minimize unintended underwriting risk and the risk to an insurer from unintended risk accumulations. One of the ways portfolio risk accumulation is managed is through agreed limits, i.e. the maximum amounts written on individual accounts, types of exposure, countries, etc. Ayling (1984) states that excess of loss catastrophe reinsurers apply a number of similar constraints such as limits on exposure for any one risk, limits on exposure by geographical area and character of risk. The similarity between the excess of loss reinsurance and PRI could be justified by the fact that both deal with large and complex risks. As one senior risk manager explained:
Participant 4: My team will get involved. If it is straight ministry of finance or treasury, sovereign obligation, then we already probably gave some guidance to the underwriters within the portfolio. You know what sort of limit they have for writing ministry of finance in X country. So they just go away and use that limit. When it gets into more territory risk then you can go down to the specific ministry and how it actually funds itself and how it relates to the central government… You know, regional and federal. Or if you’re looking at very specific credit risk, we will do the actual analysis.

The most commonly cited limits adopted by PR underwriters for controlling portfolio risk were country, sector and insured limits. In other words, an insurer sets the maximum amount it can write on any one country, sector or insured. Consider the following:

Participant 5: We have country limits, we have obligor limits, and those are sort of formal constraints. And the size of our particular book in a particular country is controlled by the relative riskiness of that, and the product mix in that portfolio.

Participant 8: Ya we have certain maximum lines, we have a certain amount of exposure that we want in any one zone, in any one area. You can use reinsurance a billion dollars base if you wanted to. We kinda set promises what is the most that we want on any of our one risk.

Wang, Monsilla, Kikuchi and Choudhury (2005: p. 43) define country limit as follows: “a quantitative limit on exposure set by many export credit insurers and international banks to monitor and control their total commitments in individual countries.” This definition is also applicable to the private PRI market. Political risk insurers also employ sector limits, i.e. the maximum liability in any one sector in a given country and across the board. The sector limits are used to minimise the probability of catastrophic loss and of overexposure to systematic risk. For instance, if the price of crude oil increases significantly, the host government may decide to pass a new law that breaches existing contracts between that government and foreign investors in order to benefit from increased prices and to boost its revenue. This in turn would have an effect on all insured risks in that sector in a given host country. Furthermore, an increase in the price of crude oil may accordingly lead to an increase in the levels of political risk in other oil-producing countries. An insured limit is the maximum amount to be insured per individual risk. The size of country, sector and insured limits depend on a number of
factors such as risk appetite and perception, the insurer’s capacity and the state of the economy, etc. This finding contributes to the further understanding of how the PRI market functions. There is a substantial gap in academic insurance literature regarding PRI and the way political risk insurers manage their book of business. This could be due to the fact that PRI accounts for only one or two percent of the overall property/casualty insurance market (Ascari, 2010) and therefore is a low priority for academics and regulators alike.

4.2.3.2 Aggregation

Data analysis indicates that aggregation is one of the key techniques in portfolio management employed in the PRI market. Unlike in the property-liability or motor insurance markets, where the risk level to society is reduced by aggregating uncorrelated risks, aggregating political risks potentially increases the variability of PRI provider’s returns, which in turn can put a policy holder’s protection in jeopardy. The law of large numbers - which states that the probability density function of a loss tends to become concentrated around the mean as the sample number increase (Freeman and Scott, 2005) - cannot be directly applied to PR exposures. For the law of large numbers to work, the risks have to be statistically independent and at least somewhat homogeneous. Political risks generally lack those qualities and therefore the benefit of aggregation for the PRI provider is lost. Aggregation becomes something a political risk insurer has to monitor since political risks, to some extent, are dependent or correlated. This also means that a PRI provider needs to maintain reserves greater that the reserves that each individual would have to maintain if uninsured. Therefore, PRI providers are very selective when accepting or rejecting risks, as interrelation among the risks can mean that a political risk insurer is assuming more risk than initially intended (risk selection criteria will be discussed in detail in the political risk selection section).

Consider the following:

Participant 10: We have an aggregate system. We grade countries from A to E loosely in line with rating agencies and how they rate countries. And that sub-divides to the nationality of the insured, so we are capturing out our exposure to any one embargo risk. That sub-divides down again to industry sectors so we are not exposed to any commodity, or over-exposed to any commodity, or over-exposed to any industry. And then the bottom line is the obligor. So we are sub-
divided all the way down. When you look at the risk you work all the way up to make sure you got all the aggregates available on every level.

Participant 4: And then from the risk perspective we report our numbers to something called Enterprise Risk Management, ERM. So again Joe really is our contact with ERM and so from all the risk that we accumulated, or aggregates than we report those numbers on quarterly basis to ERM.

Participant 1: Where you want protection I guess is on the accumulation so you want protection on Russia or correlation of certain industries or oil price. That kind of thing. I don’t know how much you have to pay for pure Russia reinsurance but I suspect that would be expensive. If it was even available.

In summation, PRI providers have to control and monitor the levels of aggregation due to the underlying nature of political risk exposures. Firstly, according to Ascari (2010), political risk in its “core” dimension can hardly be defined statistically. There is no actuarially-approved method to link events behind political risk to the probabilities of their expected losses. Secondly, political risk is a discontinuity in the trend; the political situation in any given country can change abruptly. Finally, political risk can take infinite and unpredictable forms, which are therefore difficult to model and manage accordingly. An aggregation system helps to minimise the levels of unintended risk and make sure that portfolio objectives and constraints are not being violated.

4.2.3.3 Realistic disaster scenarios

Political risk insurance as a class of business is exposed to catastrophic losses. PRI providers test their capability to meet all their commitments against a number of realistic disaster scenarios. This is carried out in order to ensure that an insurer holds adequate capital resources to offset significant year-to-year variations in loss experience, which in turn ensures a reasonable degree of stability in the portfolio returns. Consider the following:

Participant 10: Lloyds prescribes realistic disaster scenarios every year. And you have to look at what your maximum realistic disaster scenario is and the percentage of your company’s capacity. We are the minimum risk relative to syndicate, therefore, even in our spike countries you are still manageable.
Participant 2: *it is about achieving in your own portfolio balance between income and the maximum loss scenario and that your maximum downside is appropriately managed.*

Realistic disaster scenarios serve two purposes. Firstly, stress tests, if carried out regularly, can reduce the probability of insolvency, as it can tell an insurer if its portfolio is too risky given its level of risk tolerance. Secondly, this technique of portfolio control makes sure that insurers are better prepared to act upon the resolution of claims arising from unpredictable and unforeseen events.

**4.2.5 Monitoring Portfolio Performance**

Monitoring and reviewing PRI business is an everyday book-keeping task. Data suggests that portfolio performance is verified on three different levels, i.e. by a political risk underwriting team, management and a board of directors. Incoming and accepted risks are internally peer-reviewed on a daily basis by the underwriting team, whose underwriting performance is closely supervised by the management and reviewed by the board of directors on quarterly or yearly basis. Consider the following:

Participant 11: *Again, it is like a normal company. You know, I have people to whom I report. I have people to whom I report in terms of business and how much money we are making or losing and whatever, and expense control, etc.*

Participant 13: *Very closely. Because the type of business it is. And in fact every risk we write the CEO has to sign it off. So it is very highly monitored.*

Participant 10: *Monitoring is constant. It is a constant thing. I speak to management... I’ve spoken this morning with them.*

All study participants from the underwriting side expressed how peer review is a part of the underwriting process that is mainly used to evaluate portfolio performance and underwriting strategy. Peer review underwriting is a relatively new phenomenon in insurance markets which has not been widely discussed in academic literature. This type of underwriting greatly contributes to transparency and disclosure. Data analysis shows that PR underwriters engage in both post and pre-internal peer review, as well as seeking external peer review. The rationale behind internal and external peer review is explained as follows.
In practice, underwriters keep three most important recording systems: individual risk cards, exposure book and claims book (Ayling, 1984). These recording systems can also be observed in the PRI market. The subject that has not been talked about much in the insurance literature but manifests itself a lot in the data is peer review. The purpose of peer review is multifold: it is used to monitor portfolio performance, reinforce underwriter’s discipline, increase the transparency and disclosure of the underwriting process, as well as help in developing underwriting strategy and pricing (based on the notion that two heads are better than one). Consider the following:

Participant 10: *Ya we all peer review each other. Just within a team, and then it gets management peer reviewed as well. When it falls outside certain parameters we have to write an order. So we have that it is all internal.*

Participant 5: *Because we are so small, we don’t have the huge volumes that other classes do, so at the moment every single risk that is written, a rationael behind why that risk was written is attached and that is also reviewed by one or two others.*

Underwriters can do pre-quote peer review of the incoming applications for insurance and post-quote review where a risk has already been accepted for the portfolio of risks. The two examples are given as follow:

Participant 10: *Post. Largely, there are certain areas in business where pre is required. But the majority of peer review is post.*

Participant 8: *All peer reviewed. Pre-underwriting results, we don’t peer review post. A lot of our competitors would quote something and then they peer review that, after they already quoted. We do prior to the process and if everybody is in agreement we quote.*

Pre-quote peer review usually takes place when underwriters are presented with a large and complex risk, when an underwriter has already ‘used up’ his or her aggregates, and/or when a risk is above certain limits, e.g. the limit on any one risk.

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10 Political risk underwriting has long been self-taught “craft” where underwriters would have undivided authority in their decision-making process, which has contributed to a lack of transparency and disclosure in the market.
In addition to internal peer review, a majority of the study participants admitted that they appoint an external peer reviewer(s) to review their book of business and at the same time to provide consulting services. The role of external peer reviewers is similar to that of non-executive directors. An external peer reviewer is not involved in day-to-day underwriting activities; rather their role is to provide an objective opinion and to evaluate the underwriting strategy. PRI providers may also decide to appoint an external reviewer to bring different skills and experience to the underwriting team, which in turn can improve overall PR underwriting performance. As one PR underwriter explained:

Participant 5: *We do more than corporate policy asks. We are a very small team anyway... So every morning we have a conference call with Singapore and we talk through enquiries, deals so there is a lot of organic peer review anyway. And there is formal peer review and it is linked to your individual authorities, whatever the things have to be peer reviewed before or they go down and reviewed after. And that is again within the team. And then we have an external peer reviewer, from outside of our company, who comes once a week; and when certain things are above the certain threshold he reviews those as well. He writes a report to a board separately. <...> And also the grown-ups [directors] change to a degree they come and go... So somebody who knows it [PRI business specifics] very well then go somewhere else... In a way that is why we have peer review from the outside, because he is a specialist and acts on the behalf of a board and underwriting committee. Because they know, he knows what we are doing. So he sort of does that role for us.*

The PRI market is a highly disciplined market where almost every single deal is pre- or post-quote peer reviewed. This could be due to the fact that it is a niche market with a small volume of risks and therefore underwriters have more time to analyse, evaluate and peer review individual risks. But, more importantly, PRI is a catastrophe line of business in which a vast interdisciplinary knowledge and a unique set of skills and experience are needed in order to structure and manage policies in a way that is profitable and maximizes the firm’s market value. Peer review helps to communicate and exchange extensive expertise and to improve portfolio performance.
4.2.4 Summary

This section provides valuable insights into how PRI providers manage their books of business. According to the grounded theory analysis, the PRI portfolio management process generally involves setting the portfolio objectives and constraints, developing an underwriting strategy and monitoring portfolio performance. The PRI market is a highly disciplined market where each application for insurance coverage is analysed in respect of stability and survival constraints, in order to make sure that policyholders and shareholders’ interests are protected at all times. In addition, PR underwriters peer review their underwriting decisions internally, as well as seek external opinion. This in turn increases transparency of PRI underwriting activities. There is little academic literature available on the subject of portfolio/book management in the area of specialist risk underwriting. The findings outlined in this section provide a new source of knowledge with regard to the portfolio management techniques employed in the insurance market for large and complex risks. In addition, data analysis shows that there is a new tendency in the London PRI market towards peer underwriting and towards peer review of underwriting results which merit further research, as it could be of interest to regulators and academics alike. Finally, this section indirectly supports Stone’s (1973) theory of capacity, which argues that catastrophe underwriting can be explained by utilizing the behavioural model for the insurance industry. Referring back to Figure 4.1, the second category of risk selection will be dealt with in the next section.

4.3 Risk selection

Moving from the first category, which looked at the portfolio management process within the PRI market, the second category of Risk Selection discusses the selection criteria employed by political risk underwriters in selecting risks for a portfolio of political risks. This category breaks into two concepts: Explicit Risk Factors and Implicit Risk Factors, which together embody the risk selection criteria. Explicit risk factors are risk properties that can be directly observed, measured and communicated from one individual to another, in contrast with implicit risk factors which are more abstract and intangible risk attributes, such as reputation and trust. Study participants
were asked to describe the process of risk selection and to identify what, in their opinion, qualified as a good political risk. Open interview structure allowed for follow-up questions which further explored the additional aspects of risk decision-making processes in the UK PRI market. In addition, risk selection criteria manifested throughout the data while study participants were addressing different aspects of the PRI business. This section contributes greatly to the body of knowledge on PRI underwriting and is the first known study to methodically explore the risk selection criteria employed in the UK PRI market.

The section is organised as follows. The first part of this section discusses explicit risk selection factors under four sub-concepts; *Country, Industry, Client* and *Policy Factors*. The second part appraises implicit risk selection factors, i.e. intangible risk properties that have an impact on the underwriting process. The concept of implicit risk factors is organised into four sub-concepts; *Heuristics, Reputation, Risk Sharing* and *Trust*, which are discussed in detail in the subsequent sections.

### 4.3.1 Explicit Risk Factors

Explicit Risk Factors is the first concept in the Risk Selection category. This concept consists of four sub-concepts: (1) Country Factors, (2) Industry Factors, (3) Client Factors and (4) Policy Factors. The concept of explicit risk factors provides new insights into the area of risk management and insurance; specifically, it sheds light on the underwriting process within the London PRI market which, to date, has received little attention from researchers and regulators alike. In addition, this is the first known study to analyse the political risk selection process using grounded theory analysis techniques. Data analysis suggests that a number of risk properties are taken into consideration by PR underwriters when selecting the risks for a portfolio of business. These can be interpreted as political risk selection criteria or as the basis for the underwriting policy. Figure 4.4 provides an overview of the concept of explicit risk factors and its sub-concepts, which are described in detail in the subsequent sections.
4.3.1.1 Country Factors

It became very clear in the early stages of the data collection and analysis phase of the grounded theory analysis that the host country plays a major role in the risk selection process. All study participants uniformly agreed that it was one of the first factors that political risk underwriters took into consideration. The sub-concept of 'country factors' can be further subdivided into political situation, economic situation and legal environment considerations (see figure 4.4). Political risk underwriters try to determine the level of political risk from host country-specific factors, such as political stability,
volatility in foreign exchange and interest rates, sovereign creditworthiness and arbitration laws. As one underwriter explained:

Participant 5: So that is insured side... Then there is the country they are in. From our point of view, from the theoretical point of view, whether someone is a dictatorship, or democracy, a monarchy, each has its own dynamics. But the thing we're looking for is stability. If we know it is bad but it is stably bad, we can price it. If it is very volatile then it is very difficult. So in a way it is stability you are looking at. Obviously, the type of government, the ethnic mix; they all have their own dynamics in terms of how stable it will be. But it is not - we only invest in democracies because democracies are good - you know, Goanna is a democracy but it is causing all sorts of problems at the moment. So definitely stability on the country side.

Similarly, Rarick (2000) argues that one should take two key determinants into consideration when assessing the degree of political stability within a country. Firstly, homogeneity or heterogeneity of the population and the relative composition of the various ethnic clusters within the country must be considered. The more fractioned a particular society is, the higher the risk of social unrest; especially when coupled with economic disparity among the different ethnic groups involved. The second determinant is the gap between rich and poor. However, this determinant on its own is not a sufficient indicator of the probability of political or social unrest, and it has to be looked at in conjunction with economic growth which can act as a mitigating factor even when the distribution of income is skewed. As can be seen from the interview extracts, UK PRI market participants adopt a parallel model in assessing degrees of political instability.

Political risk underwriters also analyse the economic situation in a host country in order to come to a subjective estimate of the level of political risk involved and consequently determine whether a particular risk of interest is acceptable for the book of business. Consider the following:

Participant 4: We look at inflation, domestic interest rates and then the external account. How do they get hard currency? How much do they have? We look at various ratios which show sustainability of the private sector, public sector. Is their currency free floating? Is it open to a speculative attack? Is it pegged? What supports that peg? That comes with the economics.
Alon et. al. (2006) state that firms, especially those operating in foreign financial markets, are particularly susceptible to the host government’s actions or inactions that are a direct response to the unfolding economic situation of the host country. The East Asian economic crisis and Latin America currency devaluation crisis are good examples of the interrelation between political risk and economic risk. Political risk cannot be analysed in isolation from economic and legal determinants, as they usually are direct causes of its escalation. The host country’s legal environment is important in the risk selection process for two main reasons: firstly, the more transparent the legal system is, the more foreseeable the political risk; secondly, if a country is allied with international governing bodies (e.g., WTO) and has arbitration laws in place, underwriters have better prospects for recovery in the case of a loss on a political risk policy. In the words of political risk underwriter:

Participant 1: What is the legal set-up in the country? How easy is it to defend against expropriation? Whether or not they signed up to ICSID, New York convention, you know, arbitration and all that kind of thing. Which can be very important. And it gives you an idea, the attitude of the country. Because if they are not signed up, then you would probably think the risk is higher. And at least the arbitration gives you a means of coming out of it... You might also look at a relationship between the host territory and the country of the company that’s going to invest or build a plant there or whatever. You know what is the relationship between those two countries and if it is bad that’s not a good signal.

The host country and home country’s international relationship also has a role to play in political risk assessment. According to the data analysis, political risk underwriters perceive a risk to be lower, or more acceptable, when host and home country governments can be considered allies. The opposite holds true; if the host country and the home country have a conflicting relationship, then a risk is perceived to be higher or unacceptable as investors from the home country are more likely to become victims of a conflict or power struggle. This is in line with Bunn and Mustafaoglu’s (1978) argument that selective expropriation of a company’s assets can be affected by its identification with previous colonial powers.

The fact that some countries are perceived a higher political risk than others aside, country factor is also crucial to the risk selection process due to diversification effects. Generally, underwriters have different levels of capacity allocated for particular host countries. Underwriters are not supposed to exceed these country limits as doing so can
result in imbalanced portfolios, which in turn can lead to insolvency in the face of a political catastrophe. Consider the following:

Participant 9: And fundamentally there is a problem that the world is imbalanced, the underwriters... You know, there is demand for more capacity in Russia, Turkey, and China where the market is turning away the business where otherwise write because the pricing is there. Because they got enough – thank you very much – they've done balance their portfolios on that country. You can’t really set up a specialist insurer just to write those capacity risks because you then have a very imbalanced book. It is quite difficult to organise the world into this thing.

Overall, a country factor was identified by all study participants as a major risk selection criterion. This is the case for two main reasons. Firstly, different countries have different levels of political risk, which can be evaluated by looking at a country’s political and economic situation, legal environment and current foreign affairs. Secondly, underwriting policy usually introduces capacity limits on every one country, which should not be exceeded without approval from the management. Underwriting policy can have a list of countries where a PR underwriter is not allowed to write business or can only provide limited coverage (e.g., breach of contract but not currency inconvertibility, etc.).

4.3.1.2 Industry Factors

The second sub-concept of explicit risk selection factors that influences the political risk selection process is Industry Factors. Some industries are perceived to be associated with higher political risk than others. All study participants uniformly believed that the power sector was of inherently higher political risk than non-key industries, such as box manufacturing. Consider the following:

Participant 5: There is a massive difference between insuring someone’s warehouse full of fridges, than insuring a power project. To be honest that is not something our market deals particularly well with. You could say it’s just political risk... No it isn’t really so... Obviously, you want a straightforward simple sector that does not have too much government involvement. In that way you are relying on, you are basically covering a client from government waking up one morning and – “aha, I’m going go and do something active in that direction.” Rather than a power project where the government is involved
routinely and you not covering government not doing something or doing something but slightly differently. So you basically want something that is just a business and has nothing to do with the government. And therefore government has to want actively to do something.

Participant 11: Obviously, if you are looking at the natural resources in certain countries, they are the first ones to get expropriated, whereas, box manufacture isn’t going be of any interest to anybody. So it is that kind of dynamics.

Industry factors can be broadly sub-divided into three groups which are as follows: (1) prime necessity industries (e.g., food, energy, infrastructure and textile sectors); (2) extracting industries and sectors that generate foreign exchange (e.g., steel and iron manufacturing); and (3) sectors that comprise large parts of tax revenue. For example, if the liquor industry produces one of the highest tax revenues in the host country, then it is more likely to attract additional government involvement and oversight, due to the fact that it is crucial to the country’s economy. The three groups mentioned above constitute industries that are perceived to be higher risk by PRI market participants. For example, when an underwriter was asked which industries in his opinion carried a higher political risk element, he responded:

Participant 4: Well I think it depends on where you are in the economic cycle. The most obvious are the extracting industries and their ability to generate hard currency and jobs, and so on. The less obvious sometimes are retail and consumer sectors and the obvious end of that is food. But even going down from that, there is the pharmaceuticals and we see this with the Russians. There is no doubt that Putin is going to interfere. You know he is so concerned with inflation that they will interfere with the pricing within these sectors. But how are they going to do that?

Similarly, Bunn and Mustafaoglu (1978) argue that a situation where a host government is not able to fund its ambitious development plans or where the projected tax revenues from industries - other than the one to which a particular foreign investor belongs - are not sufficient, can lead to adverse changes in the tax rate in the industry to which the foreign investor belongs. In other words, if a foreign investor’s industry is perceived to not be paying enough taxes, taxation is increased, which can consequently result in the creeping expropriation event. Overall, an underwriting policy can have a criterion that specifies which industries political risk underwriters are, and are not, allowed to write, as well as to restrict capacity limits on any one industry.
The third sub-concept of the explicit risk factors concept that manifested itself throughout the data collection and analysis processes is Client Factors. As in any other insurance business line, a prospective insured is a key subject to an underwriting function. Moral hazard and adverse selection problems associated with insureds are well known in insurance markets (Shavell, 1979; Dionne, 1983) and are also present in the UK PRI market. Political risk underwriters seldom have direct contact with the risks they are considering for a book of business. They do not, usually, interview potential insureds personally. They gather information from other sources, most commonly from brokers and various media outlets. Client specific factors that play an important role in the risk selection process are classified as follows: (I) financial position - where a higher financial status of a client signals a lower risk; (II) overseas experience - perceived as a positive feature if prospective insured has been trading internationally or successfully operating its business in a foreign market for a number years; and (III) social parameter - where risk levels are believed to be lower if a client makes a positive contribution to a local community or region in terms of philanthropy and other means.

Consider the following:

Participant 6: So insureds are crucial both in terms of their experience and their financial strength. As we talked earlier, if they are short of money that limits their options. It means it is harder for them to get out of the trouble or to deal with the problem proactively.

Participant 4: The insured is very important to us. They got to have... Certainly, they have to have the knowledge of types of products they are financing... You know, if you suddenly saw a bank getting involved in per-export financing stuff who has never in the history done this business before, then you have some significant questions about their ability to actually manage that risk and meet their apps of warranties and keep control of it and structure properly. Similarly, when you are dealing with the contractor, for example, from France operating in the former French West African colony they have been there for 30/40 years, they know what the political set-up is and they know how to handle it.

The practice of differentiating potential insureds according to their financial status, experience and social perimeter is one of the risk classification methods that has an impact on coverage, premiums and access to insurance in the UK PRI market. This classification method can be rationalised as follows: low financial status of a potential
insured sends the message to an underwriter that it is this type of client that is more likely to have false insurance claims. In addition, insureds of low financial strength may not be able to afford to maintain their overseas investments adequately, which in turn can trigger a host government’s actions, which can lead to losses on PRI policies. Further, the first-time foreign investor is new to the international markets and therefore is more prone to encountering difficulties due to lack of experience and/or essential skills for operating in the emerging and developing markets. Finally, if a potential client practices corporate social responsibility it sends a signal to the market, as well as to an underwriter, about its character. Such as an applicant is perceived as less likely to commit insurance fraud and/or is less likely to suffer a loss from activities that PRI providers are unwilling to condone. Corporate social responsibility can also work as a risk mitigation tool. This is in line with Spagnoletti and O’Callaghan (2011), who argue that lack of corporate responsibility and accountability to the local community can lead to increased political risk. The importance of an insured’s social parameter was emphasised by an underwriter as follows:

Participant 7: First of all we look at the client what do they do as an industry. What is their profile like globally within that industry? Do they have, as the Control Risks uses, a social perimeter? Do you build schools and medical facilities for local villages? And actually a lot of clients they are much more informed and educated on the importance of that side of things now then they have ever been. We want clients that are proactive on that side of things. Actually, being realistic about the risk they face... I like dealing with clients who insurance is the last thing they think about rather than the first. Because if it is last thing that they think about, they have thought about how to mitigate it, how to protect... You can’t... Certainly for some of our clients you can’t prevent this risk, but you can prepare and you can mitigate.

Thus, according to the grounded theory analysis, if a prospective client has a strong financial position, experience in operating within or dealing with foreign market(s) and engages in corporate social responsibility practices, they are perceived to belong to a category of lower political risk. These qualities can help a potential insured to get the coverage it desires as well as to obtain a comparatively lower premium rate. The comparison could be made with life insurance, which distinguishes between men and women; or with motor insurance where young male drivers are charged higher insurance premiums or are in some cases refused coverage (Wils, 1994).
4.3.1.4 Policy Factors

Policy factors such as the type of coverage demanded by a client and the tenor\textsuperscript{11} have a role to play in the political risk selection process in the UK PRI market. An underwriting policy may specify the kinds of coverage an underwriter can and cannot write, as well as indicating the preferences for particular types of coverage. Grounded theory analysis suggests that political risk insurers generally favour trade insurance products (e.g., supplier or buyer credit business policies) to investment insurance products (e.g., confiscation, expropriation or currency inconvertibility policies). As one underwriter explained:

Participant 10: And non-payment if you don’t get paid - if you have not met the conditions of the policy - you can pick up your claim payment from an insurer. And same with non-delivery, if you haven’t received what you expected to receive it is very obvious. And it is very well documented. On the expropriation basis, very few people use the words expropriate and therefore you automatically in the position of going has it happened or hasn’t it happened? It is much less clear-cut. It does not happen that often but it is much less clear-cut.

Expropriation risk, which is catastrophic by nature, has changed over the past two decades. It has been diminishing in its classic form (e.g., outright expropriation act) because governments around the globe are adopting more liberal approaches to FDI, as well as starting to comply with the WTO policies on arbitration and awards. This liberalization trend can be reversed during periods of recession as a result of domestic pressure from trade associations, unions and unemployed forces on host governments to respond protectively to local interests (Galvao, 2001). It is also important to note that the nature of expropriation risk has evolved as host governments have become more creative in expropriating foreign investor’s assets, e.g. through export/import license cancellation, regulation and taxation, which are largely outside WTO’s scope and power and are more difficult to defend against. From the investment insurance point of view, perils such as confiscation, expropriation, creeping expropriation and deprivation do not have well-defined triggers and as a result tend to carry a degree of ‘grey protection’ (e.g., where it is difficult to establish if insured event has happened or not), which in some cases make PR underwriters reluctant to provide coverage (e.g., against

\textsuperscript{11} The term of a political risk insurance contract
expropriation act in certain countries). Issues concerning investment insurance policies were also emphasised by political risk brokers. As one broker argued:

Participant 9: I’m quite interested in this, because I don’t think that we really have a product in this area [investment insurance]. Which is the traditional investment insurance, equity, and lenders and the problem with the equity – forget about the lenders we’re not big fan of that product; it is a very difficult policy to claim on except currency inconvertibility.

In contrast, trade insurance products are unambiguously defined with policy wordings having a relatively standard format throughout the London PRI market, which reduces the element of grey protection to a minimum. Trade insurance products also appear to meet more of the requirements of insurability than do investment insurance products. As one study participant explained:

Participant 12: Investment insurance is a much harder product to pin down. Because when you insure a loan – the reason why you get a loss is very clear. You are expected to be paid on a certain day and the money doesn’t come through. The bank then asks for it, either there has been a mistake that is rectified; or it’s not going be paid and then it is very clear option. Is it because they can’t pay because they are insolvent or they won’t pay because in the government case they chosen to be difficult. And then there is sort of negotiations about restructuring if possible and so on. That all proceeds from a very clear trigger. Trigger event is non-payment.

The second aspect of policy factors that has an influence on the risk selection process is tenor, which is the term of the PRI contract. Generally, PRI policies are long-term contracts ranging from 3 to 5 years, and in some cases 15 years and beyond. According to the grounded theory analysis, PRI applications might be rejected if the requested coverage period (tenor) is above a certain number of years. An underwriting policy usually states the maximum number of years a political risk underwriter can commit his company’s capital to for any one policy. For example, one study participant reported:

Participant 3: We write a maximum of 10 years or 5 years for PR. But in my personal opinion, given the economic cycle, you don’t want be writing more than 5 years... Three years ideally if you have the situation that we have now where everybody is collapsing and not paying their debts.

Political risk brokers are intermediary in the PRI market and hence are a good source of information. They know the market very well as they generally have established working relationships with a number of different PRI providers. For this same reason
brokers were asked what they thought was the cut-off point for the tenor of a PRI contract that underwriters would be willing to accept. The political risk broker answered as follows:

Participant 12: Well broadly... The most between 3 and 5 years is relatively easy. Non-payment can go longer and some underwriters would write for 10 year periods for project risks or even longer. But I would say Lloyds underwriters tend not to go beyond 3 to 5 years, whereas companies can go up to 5/7 years.

According to the data analysis, the tenor factor not only has a role to play in the risk selection process, but also in informing the underwriting strategy, which helps a PRI provider to position itself competitively within the marketplace. In other words, it allows a PRI provider to differentiate itself from its competitors. Consider the following:

Participant 1: The tenor of the risk is quite important. In the sense, that the longer you go, the more competitors you are rolling out. So if the broker comes in and says it is ten years. It is ten-year loan that would really restrict the number of markets that could actually do it. Now that would obviously give us greater leverage over pricing. How much we could push basically.

Generally, the underwriting aspect of risk selection has more options than just the two alternatives of accepting or rejecting an application for insurance. There are several other options. Political risk underwriters use their judgement and experience to decide whether to accept a risk without further action, to accept a risk but only provide limited coverage and/or shorter tenor, or to reject a risk as a last resort. In other words, an underwriter will always try to find a way to make a risk acceptable for his/hers portfolio of political risks if there is a possibility.

4.3.2 Implicit Risk Factors

Political risk is a complex phenomenon which, in most cases, cannot be statistically described. Often political risk underwriters are presented with risks that are unique and that have not been underwritten before in the PRI market. Moreover, even for risks where limited historical data is available, the political environment surrounding these risks can change abruptly as a result of political turmoil and/or unforeseen host
government actions and inactions, which in turn makes political risk modelling an extremely challenging task. Therefore, it does not come as a surprise that in some cases underwriters have to rely partially, or solely, on their personal judgment and tacit knowledge (Polanyi and Sen, 2009; Polanyi, 1966), which PR underwriters refer to as intuition, instinct, gut feeling or sixth sense. Consider the following:

Participant 10: It is what we see isn’t it? <…> So how do I select [Political Risks]?
– It is gut instinct. There is nothing better than that actually.

Participant 7: There is no matrix. Which in some way is good, because the next step from there is having a computer to do my job. But actually the personal sort of being objective about the risk being written, being realistic. A lot of this is gut feeling. Actually the more informed you are, the harder you work to make sure you know what is going on. But at the end of a day the humans have evolved. Sort of gut feeing - the sixth sense – when some things aren’t right.

Participant 12: But the actual process [Political Risk Insurance Underwriting] will vary from syndicate and company. Some people have very structured processes; some tend to do it in more... It is more of a judgemental way. They have a gut feeling or instinct.

According to the grounded theory analysis results, the risk selection criteria consists not only of explicit risk parameters such as the host country or policy factors (see the Explicit Risk Factors concept), but it is also effected by the political risk underwriter’s risk perception which is impacted by a number of factors. Pidgeon’s et al (1993) argue that risk perception involves people’s beliefs, attitudes, judgements and feelings, as well as the wider social or cultural values and dispositions that people adopt, towards hazards and their benefits. The argument of Espein (1994), Sloman (1996) and Slovic et al (2004), that individuals comprehend reality by two interactive, parallel processing systems (i.e., rational and experimental systems) that can be used to validate the risk selection process in the UK PRI market. Where the rational system is an intentional, logical system that functions by way of established rules of reasoning and evidence (e.g. probability theory), the experiential system encodes reality in narratives, images, and metaphors to which affective feelings have become assigned. A relative comparison could be made between the rational system and explicit risk selection criteria, and the experimental system and implicit risk selection criteria. It is important to understand which variables influence underwriter’s risk perception in order to be able to evaluate the effectiveness and the soundness of the risk selection process within the PRI market.
This is the first study known to analyse political risk perception that forms the implicit risk selection criteria in the UK PRI market.

It is difficult to say to what degree political risk underwriters are equally worried about the same risks, or to what extent they perceive certain risks as good and others as bad. With the help of grounded theory analysis techniques, this study aims to uncover the ‘taken for granted’ realities, beliefs and attitudes that affect the PR underwriters’ perception and risk selection processes within the UK PRI market. The four sub-concepts of Implicit Risk Factors concept that emerged from data analysis are as follows: Heuristics, Reputation, Risk-sharing and Trust. The subsequent sections discuss the implicit aspects of political risk selection criteria in detail.

4.3.2.1 Heuristics

The PRI market is a distinctive phenomenon in the insurance sector. Underwriters encounter unique and uncommon risks in the PRI market on a daily basis, risks for which historical and statistical data are simply not available or are difficult to obtain. Data suggests that when political risk underwriters have to make an underwriting decision under uncertainty, or with incomplete information, they tend to employ memorability and imaginability heuristics in order to assess subjective probabilities and/or envisage possible outcomes and scenarios. There has been little research done in the area of specialty insurance and how these markets underwrite their risks. This is particularly the case for the PRI market where a substantial literature gap exists in the area of political risk underwriting. This study contributes initial insights into political risk perception and into the underwriting practices that take place within the London PRI market.

Memorability

According to the data analysis, political risk underwriters assess the subjective probability of a possible loss through the ease with which examples or occurrences of similar events can be brought to mind or envisaged. This finding is in line with Tversky
and Kahneman’s (1974) theory of availability heuristics, which states that large classes are usually recalled better and faster than instances of less frequent classes. Thus, it could be argued that political risk underwriters judge a particular risk to be higher if the instances of a loss from a similar risk can be recalled or imagined. This is not to be confused with experience rating in insurance, which incorporates the history of the policyholder in the ratemaking process to arrive at a fair premium price, even though the connection between the two could be made (Pinquet, 2001). Consider the following:

Participant 1: *Well you can use your knowledge of previous losses and why they’ve happened, I suppose. Or a political risk underwriter will do that.*

Participant 11: *I think the reason you never forget your basics is - the world always finds an excuse why he should do something. And that is where you have to be careful. Argentina is a great example. Argentina has gone nowhere in the last 9 years. It hasn’t really dealt with its foreign debt at all, and it dealt with it very badly, and yet you have banks flooding in there again doing money. On what basis? You know, the economy is awful. But they somehow found an excuse why it is a good idea to start lending back into Argentina again.*

As can be seen from the above interview excerpts, underwriters use their personal as well as the PRI market’s past loss experiences in order to gauge a level of political risk. It also appears that underwriters are inclined to stigmatize certain countries where there have been previous losses and where the host country attracts large volumes of negative publicity. As a political risk broker explained:

Participant 12: *In the broker’s view, you should be able to do anything anywhere [place a risk] in theory, but in practice if you look at some countries... Take Venezuela, for example, no one really in their right mind would want to insure an oil services company doing business in Venezuela. Because if they are already, there what are the chances that they are going get nationalized if they haven’t been already? If they are new going into, why on earth would you want to insure into the place which has currently very poor record of treatment of investors? So as a broker you are going to say – look, that is a waste of time.*

When a broker introduces a risk to an underwriter, the two first things that the underwriter is going to look at are: what is the host country and what kind of coverage is requested. If loss instances or occurrences can be recalled, the risk is said to belong to a category of higher risk, everything else being equal. The PRI market is a conservative market; that is, it is very selective and sensitive in regards to risks being underwritten. A
shift in risk perception towards the higher end can be triggered by a relatively minor international event within the space of a few hours, but it can take years to restore PR underwriters’ confidence and willingness to insure a risk in that particular country or region again. Arguably, this could be attributed to the catastrophic nature of political risk, which makes political risk underwriters highly selective and/or risk averse. In summation, if an underwriter can recall, either personally or through the experience of another, a similar insured/uninsured loss experience, a risk of interest is perceived to belong to a category of higher risk.

Imaginability

Imaginability is the second element of heuristics that affects a political risk underwriter’s perception. Some political risk underwriters employ formal risk evaluation techniques and/or get assistance from their risk management departments, while others adopt more of an intuitive and judgemental approach. No matter the political risk underwriting philosophy, underwriters have to look beyond the initial political risk assessment and try to anticipate what factors can trigger a host government’s actions or inactions, which in turn can result in a loss on a policy. This exercise involves analysing international relations and wider social and economic circumstances in order to foresee future political developments in a country of interest. Consider the following:

Participant 2: It is slightly different with multilaterals [refers to co-insuring with a multilateral PRI provider] ... If I was a Machiavellian dictator, the only people I wouldn’t want to upset is the World Bank. Such an upsetting thing to do! That basically puts you at the bottom of a pile in terms of help going forward. If I’m that Machiavellian dictator, those are the only people I would not like to upset. Maybe my number one agenda is to upset the US government but I probably do not want to upset the World Bank. I always thought the multilaterals are different.

Political risk underwriters regularly try to anticipate a host government’s and/or particular political leader’s future actions, especially when the political situation of the country in question is rather unstable or uncertain. They employ memorability, imaginability and similarity as cues for probability considerations. This finding is in line with studies by Tversky and Kahneman (1974) and Slovic et al (2004), which puts forward the proposition that people rely on availability heuristics to reduce complex
tasks of predicting values and assessing probabilities. The rationale behind the political risk underwriters’ usage of heuristics, i.e. memorability and imaginability in assessing a level of political risk, can be justified by the fact that the source of political risk is human nature, which is difficult to gauge with any degree of precision. Consider the following example:

Participant 4: I think it is incredibly difficult to define political risk. I think Ukraine is a great example, what some people might see as an economic credit risk - it is not - it is a political risk. It’s more political risk than it is a credit risk. You know, Ukraine was going into this crisis... If you looked at Ukraine’s public sector’s debt ratios, etc., and its trade record over the seven years, you’d have said it is a country that should be still able to turn to international markets at a sovereign level and fund a private sector, you know. Take some of these companies pump in liquidity, pump in liquidity into banking system, even nationalize the banking system if it is needed to, which you probably need to do. And we did... We ran some numbers on it [refers to the internal risk analysis model] to work out how much money they would need to pump in. And ya, it was going to hurt for a few years but it wasn’t impossible. The problem was they’ve lost all credibility with markets, because of the political situation. There was no one to take a decision or no one to be willing to take a decision and they were all pointing fingers at each other, you know, to get ahead for the January 2010 elections.

Political risk is influenced by a number of political, social, economic, financial and cultural drivers with the strength of different drivers varying from country to country and from one potential insured to the next. There is no universal method of quantifying or evaluating political risks. It is a complex class of business which in many cases requires creative underwriting decisions and solutions. Heuristics principles such as memorability, imaginability and similarity can help to simplify the tasks of assessing the probabilities of some political risks. But this can also lead to severe and systematic errors, according to a number of studies (Tversky and Kahneman (1974) and Slovic et al, 2004). The godfathers of heuristics research and the developers of the prospect theory, Tversky and Kahneman (1974), argue that the most common biases when making judgements under uncertainty using availability heuristics are as follows: biases due to the retrievability of instances and to the effectiveness of a search set, biases of imaginability and illusory correlation. It is difficult to say how biased political risk underwriters are when selecting risk for their portfolio.

Data also suggests that political risk underwriters are heavy users of media and resource agencies, which could imply that political risk insurer’s perceptions may be affected by
the media. The insurers gather information from credit rating agencies, intelligence agencies, journals, news watch services, consultancy companies and international governing bodies, which is then used for ranking political risks or for assigning a subjective probability of loss to unique political risk risks. Consider the following:

Participant 2: *We use the credit agencies on a country level basis, solvency ratings, and then we use internal AIG’s database for political risk. Then we use consultancy companies and intelligences agencies.*

Participant 4: *Well our own view, we have been around for a while and with a lot of the information now being fed through by NGOs and all sorts of kinds of agencies we think there is a way we might be able to separate those factors and forecast a little bit better [refers to PR rating].*

Participant 6: *We do. We do use all sorts of credit agencies, news watch services, etc.*

Participant 9: *Even when the product has not evolved, the fashions of what we have been underwriting have changed with the economic climate. And finally, it is far more connected to what you are reading about in the newspapers, both political and economics than the most other classes of business. And I suppose what took me into the field, in the first place, was I wouldn’t say that as if I was a great reader of the Economist - I am not - but I have always been interested in and have been interested in international politics.*

Individuals use media in a non-intentional way by means of ordinary news and programmes or articles and in an intentional way in order to change their risk perception (Slovic, 1986). Both intentional and non-intentional use of media can have an impact on risk perception. The heavy usages of media and resource agencies can introduce some degree of risk selection bias. For instance, Linchtensein et al.’s (1978) study has shown that people were more inclined to overestimate the frequency of highly publicized causes of death like homicides, tornadoes and cancer while under-publicized causes like diabetes, stroke and asthma were underestimated. It can then be argued that host countries which attract negative publicity are perceived to belong to a category of higher political risk, everything else being equal. However, this may or may not be a true representative of real risk. Power (2004) states that the media is an important source of amplification, which is in line with Combs and Slovic’s (1979) argument that frequent media exposure gives rise to a high level of perceived risk. A number of researchers have criticized the mass media for engaging in selective and biased reporting which accentuates wrongdoing, conflict and drama and which, in turn, can have a foremost effect on risk perception (Slovic, 1987; Johnson and Covello, 1987, and
Soumerai et al., 1992). Furthermore, Mazur and Lee (1993) conclude that it is not the content that influences people’s beliefs, but the sheer amount of coverage. According to the data analysis, media and resource agencies do influence PR underwriters’ perceptions. How strong this influence is, and what its properties are, are outside the scope of this study.

4.3.2.2 Reputation

*Reputation* is the second sub-concept of the implicit risk factors concept. All study participants uniformly identified that client reputation plays an important role in the risk selection process. From the data analysis, it is apparent that where a potential insured has a long history of successful cross-border trading and a record of doing business in the foreign markets, as well as being a well know/established entity, it will be perceived by political risk underwriters as less susceptible to a loss. Consider the following:

Participant 2: *From the contract frustration risk point of view, you know, not paying on your loan or whatever... Or not meeting oil delivery... The reputation is a massive factor.*

Participant 1: *And I think, you know, when those risks were actually written most people just said ya that is risk but this company has been going for 50 years. It has a fantastic reputation. It’s a company that, you know, trading with Western Nations for years with no difficulties culturally. So, you know, there was no question whether or not they would default on their obligation... And I think that may have encouraged people to put that risk in a positive light and maybe turned a blind eye to certain lack of disclosure or, you know, financials that kind of thing.*

A number of researchers consider reputation to be learned over time from observed performance of some exogenous characteristics of agents, like borrower’s repayment record and accounting information (Diamond, 1989; Kreps and Wilson, 1982a; and Milgrom and Roberts, 1982). In the PRI market, the exogenous characteristics of agents can take such forms as cross-border trading record, payment history, potential insureds participation in philanthropic activities or how well-established the brand name is. Consider the following:
Participant 11: *Depends on how well the name is known. Because a well-known name on a short-term basis you can make a decision very quickly. If it is not - we have to do work and we have to do work. And it will take time.*

Participant 7: *Okay. The key one is - who is the client? We truly believe... The breath of business that we do; I think good clients are good risks, from my point of view, even in the most difficult parts of the world.*

Client reputation is a significant factor that influences and shapes perceptions of underwriters, as well as it being a part of implicit risk selection criteria in the UK PRI market. The issue of reputation manifests itself throughout the data in a number of different contexts. The effect of reputation in insurance markets is an under-researched area of interest. To date, most studies have focused primarily on the insurer’s reputation and how it influences client’s confidence and choice of coverage provider (e.g., Zboron, 2006; Gaultier-Gaillard and Louisot, 2006; Harris, 2005). There is even less research done into how an insured’s reputation impacts on risk perception, selection and pricing in the specialist insurance markets. Quinn (1998) argues that the presence of a potential reputation loss lessens the moral hazard problem in the medical malpractice insurance market, which in turn allows insurance companies to adopt community rating without fear that the physician will behave in a more risky manner. Similarly, outside the insurance discipline, Diamond (1991) and Milgrom and Roberts (1982) show that reputation effects on decisions occur when an agent modifies her or his behaviour to influence the data that interested parties may employ in learning about them. There is a link between the need to monitor agent’s actions and reputation in the credit markets. The demand for monitoring can be eliminated by reputation effects when an agent’s ability to raise external capital, e.g. issuing a bond, can become economically unfeasible due to the information revealed by defaulting on debt, which in turn can limit his or her opportunities to invest into positive NPV projects. Thus, reputation alone can eventually reduce the moral hazard issue as a better reputation achieved over time would lead to less severe adverse selection (Diamond, 1991). This is in line with the data analysis results which suggest that reputation is a significant factor in the risk selection process, especially when the risks underwriters are dealing with have no historical record. The PRI market is highly selective and both client’s and broker’s reputations matter when it comes to risk perception and, consequently, the risk selection process. If Diamond’s (1991) theory of monitoring and reputation holds in the PRI market, it would suggest that potential insureds, assumed to have a good reputation, are less susceptible to moral
hazard problem. There is a gap in the insurance literature regarding the reputational
effects on the insurance business which needs to be further explored. This is particularly
the case, according to the data analysis, in the PRI market where reputation appears to
play an important role in the risk selection process.

4.3.2.3 Risk-sharing

The third aspect impacting upon political risk underwriters’ risk perception, and in turn
risk selection, is joint participation with a multilateral insurer on any one risk. Public
PRI providers not only fulfil the insurer’s role, but they also provide dispute mediation
services that enable the agencies to prevent formal claims from arising (Moody, 2005).
Arguably, multilateral insurance providers have more leverage in resolving
disagreements between foreign investors and the host governments in developing
countries compared with private PRI market providers. There is a general consensus
that private market insurers often perceive risk-sharing with a multilateral insurer as a
positive factor which can put a risk of interest in a more positive light. As study
participants explained:

Participant 12: The private market would work with multilaterals, there is no
problem. There is a good presence of private markets and multilaterals providing
their capacities on the same projects. <…> That is definitely a positive factor of
having multilaterals.

Participant 10: It has not been proven... Yes arguably, the multilaterals would say
that you hide behind their international status.

Participant 4: That’s the theory. If you sit beside... We work in two ways with
MIGA as a co-insurer, so we are alongside them, or we work as reinsurer through
MIGA. That is the theory. I mean this is what multilaterals will always tell you.
You know - “we are big and we also sit around in our board meetings, the
Ukrainians won’t be pointing finger at us” and everyone around the table
shouting at them. Today I mean you have a very few examples where the situations
got bad enough that those discussions had to happen. I guess Argentina was the
last one MIGA had and it seemed to work.

Similarly, West (1999) states that coinsurance agreements with Multilateral PRI
effectively increase available insurance capacity for project developers and augment the
deterrent benefit for both insureds and insurers. There are two common types of risk-
sharing agreements in the insurance sector: (1) deductible policy, where an insured party
has to bear some part of a loss; and (2) a proportional coinsurance contract in which the insurers compensate only a prorated amount of each claim (Harpaz, 1986). The combination of deductible policy and coinsurance contract provisions is commonplace in a number of business lines. Risk sharing provisions can be used as a screening device to solve or lessen adverse selection problem (Rothschild and Stiglitz, 1976; Spence, 1978; Ligon and Thistle, 2008).

Unlike coinsuring with a multilateral insurer, cooperating with an Export Credit Agency (ECA) is perceived less beneficial from the private PRI market perspective for two main reasons, as expressed by the study participants. The ECA acts on behalf of a home government and this inevitably leads to an additional political risk dimension being inbuilt in the insurance policy. In other words, in cases of dispute the disagreement is going to be between the two governments where conflicting bilateral relationships can lead to increased levels of political risk and where the insured party can occasionally become a victim of an argument between two governments. As one political risk underwriter explained:

Participant 5: The problem from my point of view with the national providers is that intrinsically you are... You have political risk on the front end and then you have political risk built-in in your insurance. Because they are fundamentally agent of the government, they don’t have to have return to the shareholders, also they just want to be a part of the relationship between their country and that country. So in terms of are they going act totally commercially? So you have a problem... Theoretically you should have more leverage at getting out of a problem that we would have. But I think that comes with other risks as well in terms of that political nature.

The second reason why public PRI are more reluctant to share risks with ECAs is that ECAs work through the Paris Club, which usually takes longer to reach a settlement in the case of a claim. Also, since ECAs are non-profit organizations, their pricing models as well as their terms and conditions are usually not compatible with the private market’s business models. The other major difference between national agencies and private insurers is the tenor offered. ECAs usually provide long-term coverage, which can be up to twenty years, whereas tenor offered by the private market is usually limited to three years (West, 1999). Consider the following:

Participant 4: No. The export credit agencies tend to work in a restructuring through the Paris Club and their alliance with the private market would be very
different for political reasons and so on... And you know we have the shareholders and we need to give them returns. So our shareholders do not want us rescheduling every 15 years or 20 years and getting £12 back a week, which ECA might live with...

Participant 10: Different kind of risks. The ECAs do things, normally, as I understand longer term, export finance transactions. Where they can afford to be a slow market. The private market is much more intuitive and quicker to respond.

Study participants were comparatively consistent in the assumption that sharing a risk with a multilateral insurer (e.g., MIGA) is perceived as a positive attribute by the private PRI market. This is compatible with West’s (1999) argument that private and public PRI providers can benefit from coinsurance agreements with multilateral PRI providers. However, the majority of the interviewees, on an underwriting side, said that they did not think there was added value to insuring with an ECA. In addition, some study participants claimed that risk-sharing with a state PRI provider can result in greater risk as there would be an additional political risk inherent in the risk-sharing agreement itself. The next section concludes the concept of implicit risk factors with the Trust sub-section.

4.3.2.4 Trust

Trust is the fourth sub-concept of implicit risk factors concept. Data analysis shows that informal trust relationships are both widespread and important in the PRI market (i.e. underwriter-broker, underwriter-client and underwriter-underwriter trust and power balance interrelations). Trust has been identified as one of the factors that has an impact on the political risk selection process, according to the grounded theory analysis results. A number of studies have tried to explore the role of trust in business activities. For instance, Holtari and Saarikangas (1994), Glover (1994) and Macalay (1963) see trust as one of the key success factors in business. Economists define trust as “implicit contracting” where a firm, or an individual, trust the other firm, or individual, to fulfil its promises and obligations (Zucker, 1986). Axelrod (1984) shows that repeated games like the Prisoner’s Dilemma create the effects of learning, communication and the “shadow-of-the-future”, i.e. the possibility of future transaction encourages cooperation between participants if it pays them to do so. In this scenario trust can be seen as a reaction to expected future behaviour (Blomqvist, 1997). Political risk underwriters
generally feel more comfortable accepting a risk if they can trust a broker, where trust is earned through shared experience on both a professional and social levels. Trust is central to building a strong interrelationship between underwriter and broker. A broker will have more information on a potential insured than an underwriter, and it is at the broker’s discretion with whom, and how, they share this information. Data suggests that underwriters have their favoured brokers with whom they try to develop and maintain long-term relationships with the aspiration of earning their loyalty, i.e. “the shadow-of-the-future” effect. This is in line with Jarzabkowski, Smets and Spee (2010) study findings, which show that trust issues between underwriter and broker play a major role in the London reinsurance market. Consider the following:

Participant 10: Yes, there is trust. I mean you are underwriting as if you were a bank, a trader, but you can’t see everything that your client sees. So there has to be trust between you and your insured. And there has to be trust between you and your broker. Because if you found out that your broker has not been as honest or scrupulous as he should have been, then you are not going do business with them again. And so I think it is good working dynamics.

In addition, when a political risk underwriter was asked whether he would work with any political risk broker, he replied:

Participant 5: No with our core brokers. Because, you know, we know them very well and they know us on social and professional basis. And we understand the risk and they understand the risk. You know, they have to represent their clients but you still can have straightforward conversation. <...> And suppose, at the end of a day, you have brokers you trust and you have brokers you don’t.

A number of researchers see trust as a function of imperfect information (e.g. Lewis and Weigert, 1985; Oakes, 1990). Blomqvist (1997, p.272) borrows Simmel’s words: “the person who knows completely need not trust; while the person who knows nothing, cannot, on rational grounds, afford even confidence”. In other words, under perfect information there would be no need for trust, as decisions would be made based on rational calculations and this in turn would also solve the adverse selection problem. If this proposition holds true in the PRI market, it would suggest that trust can be used as a tool to manage adverse selection problem. It is, however, important to note that the underwriter-broker relationship is a “two-way street” where brokers have their bargaining power as well. As one political risk broker explained:
Participant 12: Broker itself has a role to play in the established relationships with market and persuading them to do business, knowing their appetites. Basically, you know, if you find that the underwriter is very difficult, is not very helpful, the broker tends to say “well I’m not going use that underwriter.” So the underwriters themselves if they want to be players in the market and get to the good clients - have to have good humour, be reasonably friendly.

Trust is the result of an interaction process where a trusting relationship develops gradually (Magrath and Hardy, 1989). Lewis and Weigert (1985) argue that trust in everyday life is a combination of both rational thinking and feeling. Thus, it can be further divided into two elements: moral trust and technical trust (Bidault and Jarillo, 1995). There is no universal definition of trust and it varies from one discipline to the next, depending on the context. Blomqvist (1997, p.282) provides a working definition of trust for business context as: “an actor’s expectation of the other party’s competence and goodwill.” This definition incorporates components of technical trust and moral trust into one phenomenon where technical capabilities, skills and know-how are attributes of technical trust and the moral responsibility, positive intentions and goodwill towards the other are attributes of moral trust. A number of study participants stressed the importance of the skill sets and technical competence of brokers, consider the following:

Participant 12: May also pay some passing attention to the broker because if they don’t know the insured but they know that the broker has a good reputation – so probably he made the right checks.

Participant 13: We only deal with brokers who we have approved work. Some brokers we wouldn’t deal with because we think they just are not big enough. Their company is not big enough. Or we don’t think they have the skill sets to bring this type of business. You know, it is a specialist business. You have to have specialist knowledge. So if, in our opinion, a broker does not know anything about that, we wouldn’t trade with that broker.

Participant 7: So we do a lot of negotiation at a box, people queue to see us. And it all looks old and traditional and you think: why is business still done in this way when we can email? Well actually sometimes there is no substitute to being in front of people and if the broker really wants to make a point and actually as an underwriter, we want to understand what the client is looking for through the broker.

Overall, political risk underwriters perceive a risk to be more acceptable if it is offered to them by their favoured broker, according to the data analysis. This can be due to a
number of reasons; an underwriter may feel that a broker is more honest with him or her about the risk if they have an established long-term working relationship. In addition, underwriters can be inclined to favour brokers with whom they have a successful trading record in the anticipation of new or return business, i.e. the “shadow-of-the-future”. At times an underwriter will accept a risk that he or she would ordinarily decline from a broker with whom there is a history of successful cooperation. This can be seen as the manifestation of trust, and/or compromise an underwriter has to make sometimes in order to maintain a successful broker-underwriter relationship. It could be argued that, in some cases, it is not only the risk itself that is being judged by an underwriter, but also the broker who has an important role to play in regards to a political risk underwriter’s risk perception and selection process. This proposition is in line with Lunvall’s (1990) argument that in imperfect competitive markets, in which a small number of traders build long-term relationships and make relation-specific investments, trust is a significant factor. To conclude, Zucker (1986) states that trust is an “externality,” a commodity or a good with real fiscal value, which improves efficiency, but not a commodity that can be traded on the open market.

4.3.3 Summary

This section of the qualitative results chapter describes the risk selection criteria used in the London PRI market. The grounded theory analysis revealed that PR underwriters employ a two-layer model for selecting risks for a portfolio of political risks. Underwriters use both explicit and implicit risk selection criteria, where the explicit criteria refer to observable factors such as county and client specific parameters and the implicit criteria are concerned with intangible factors like trust, reputation and intuition. A risk, if it is to be insured, has to satisfy both explicit and implicit risk selection criteria. This two-layer model helps underwriters to manage issues arising from adverse selection and moral hazard in a more effective and efficient way. This kind of model has not been discussed in risk and insurance literature prior to this study and could be of interest to researchers and regulators alike. Finally, it contributes to the transparency of the PRI underwriting practices that take place within the UK PRI market which, to date, have been perceived as an ‘enigmatic’ field of risk and insurance.
4.4 Pricing

Pricing is the third core category that emerged from the grounded theory analysis. This category contributes a substantial body of knowledge to an area of specialist risks pricing in the London insurance market which remains an under-researched and under-theorised field of risk management and insurance. A private PRI provider is similar to other profit-making organizations; however, there are two distinct differences in regard to product/service pricing. Firstly, a political risk insurer does not know what its actual cost of production will be when the contract is sold and that cost will not be known until the policy has expired. PRI contracts can be ten years and longer, which integrates a higher degree of uncertainty into the pricing process. Secondly, PRI provider’s rates are, to an extent, subject to government regulation, e.g. Solvency II capital requirements.

The pricing category has five concepts. The relationships between the concepts in the political risk pricing category are presented in figure 4.5. According to a grounded theory analysis, PR underwriters can employ one of three different approaches to pricing, which are financial economic, rational and combined methods. All three approaches are guided by the same pricing principles that are discussed in detail in the next section. An underwriter’s decision on which pricing approach he or she is going to adopt will be influenced by the quality and quantity of available information for pricing of a particular risk, as well as the nature of that risk (e.g. non-payment risk vs. expropriation risk). The subsequent sections discuss each of these concepts in detail.

Figure 4.5: Political risk pricing framework
4.4.1 Pricing Principles

Grounded theory analysis shows that political risk insurers obey the same pricing rules as the rest of the insurance sector; however, their pricing methods differ significantly within the scope of pricing principles and objectives. In other words, the principles determine the rules of pricing, but it is up to the underwriters to decide what pricing methods and models should be employed in the pricing of political risks, as long as they obey the principles of equity, adequateness and reasonableness. According to Denenberg et al. (1974), the main principles of ratemaking are equity, which refers to the fair treatment of individual insureds, and reasonableness; that is, rates should not be excessive for competitive or regulatory reasons. In addition, Black and Skipper (2000) state that life insurance pricing methods have to fulfil all three objectives; equity, reasonableness and adequateness, e.g. rates should take into consideration uncertainty about future cash flow fluctuations.

From the data analysis, it is apparent that rates charged in the PRI market are in accordance with the basic principles of insurance pricing. Political risk underwriters categorise individual insureds into distinct classes by their host country and their business occupation and by the type of coverage requested. Each political risk class is then charged premiums corresponding to the expected losses and other costs that insureds transfer into the PRI pool. This is done in order to make sure that no unfair subsidization exists of any class of insureds by any other class of insureds, i.e. the equity principle (Ayling, 1984). In addition, Kunreuther (2002) argues that categorization of risks in the insurance market helps to reduce adverse selection problem. Consider the following:

Participant 7: We also have to make sure that there is some sort of relativity in our pricing. The risk in South Arabia should pay a higher price than the risk in Lithuania. That is really important.

Participant 4: The models give the underwriters a relativity of risk between the countries... And say, well we should be charging within this sort of range for these types of risks. At some point, I would like to get our models as sophisticated as banks. In fact, there is no insurer that has pricing models for our type of business that banks would have for market risk or credit risk. I mean banks are well ahead insurers in pricing risks.
As it can be seen from both interview extracts above, the categorization of individual insureds by risk location, occupation and type of coverage allows political risk underwriters to incorporate the principle of equity in their pricing process. In addition, it also helps to manage the adverse selection problem.

The second pricing objective is that the PRI premiums must be adequate to cover the benefits signed under the company’s insurance products. Rate inadequacy can lead to severe financial problems, or insolvency in some cases. According to Black and Skipper (2000), rate adequacy means that, for a given block of policies, total premiums collected by the insurer plus the investment earnings must be sufficient to compensate the current and future losses on the insurance policies, as well as to cover related expenses. The grounded theory analysis suggests that PR underwriters have established a floor price, below which the indicated political risk pricing is not acceptable as it is insufficient to cover the cost of expected loss. Consider the following:

Participant 2: *On one level it is like selling cabbages in the market. If I sell cabbages every day I basically know what I can sell the cabbages for. I know what I can sell Ghana for… I know what I can sell Angola for… You know… Because I see these things every day and I’ve seen those for a long period of time. That is on one level. Another level is risk and reward. Market might tell you that the price for writing an oil rig in Afghanistan is 3.5 % and 4 %. You might look at this and say well that’s not enough money for me to make me want to write that risk.*

Participant 7: *In any class of business, underwriters will be sure about two things. First of all, what is the lowest price you as underwriter are willing to take.*

Participant 3: *It’s about what is the minimum you want for your capital.*

The third objective of PRI pricing is that premiums should not be excessive for competitive reasons. This requirement can be attributed to the reasonableness principle. Political risk underwriters adjust their pricing to reflect market conditions as well as the phase of the underwriting cycle (e.g. in the hard market phase risks are priced a bit higher). A PRI premium can be readjusted depending on the level of capacity available for a particular risk of interest in the PRI market. In order to maximise the overall return on capital, an underwriter can charge a higher premium if there is a capacity shortage and a lower premium if there is a capacity surplus. However, the premium charged has
to satisfy the adequateness principle so that survival and stability constraints are not violated (see political risk portfolio management category). This is consistent with the existing PRI literature (Palmer, 2009). When underwriters were asked to explain the rationale behind some of the PR pricing philosophy, they said:

Participant 11: We are driven by the market conditions. However, we have our own view. So we will have a view where the risk should be priced and it is whatever we can match that.

Participant 4: It functions as a proper market. There are no questions... You know, sometimes you have too much capacity in the market that tends to drive the price down and then you have some other times... There are some countries that suddenly you might find there is a capacity shortage that is an opportunity for players to push the price a little bit.

Participant 10: At the moment it is fine because the pricing is high. So I can stick to my pricing model as my floor price and I am comfortable in excess of that on all of my deals. When the market turns then you can start exercising commercial judgement. As long as, in the round, you are paid eight according to your pricing and one slips under. As long as that commercial justification makes sense, that would be fine. Brain makes the difference.

The pricing principles outlined above are directly linked to the portfolio management objectives of survival, stability and profit. Political risk underwriters are trying to set rates in such a way that they are able to earn a required return while maintaining survival and stability. As mentioned earlier, the principles of equity, adequateness and reasonableness are used as the guidelines and rules that have to be obeyed by the pricing methods and models adopted in the UK PRI market.

4.4.2 Information for Pricing

The ratemaking function is the process of forecasting future losses and estimating expenses and allocating these costs within the pool of insureds (Vaughan, 1999). The pure statistical models, based on probability theory and actuarial science, are of limited use in the PRI market. This is due to the fact that historical data is not always present, and where it is available its distribution is highly skewed, making a statistical approach defective for the pricing of PRI contracts. In addition, political risk by its nature is ill-
suited for statistical analysis, i.e. political risk losses *per se* are not random or accidental due to the inbuilt human component of political risk phenomenon (Gordon, 2008). Consider the following:

Participant 4: *I mean you can’t model. Every emerging market is different. There is just no way around it. Every country is different.*

Participant 6: *There is a lot of stuff that goes into it [PR pricing model]. I use the actual computer model in a relatively simplistic way because there are so many dynamics. Specific deals can be very different for different insured.*

Participant 1: *And it is difficult to generalize because the risks are so different. You know, it is not like cars – they are all the same – risks here are so different from one to the next. I don’t know whether you can say if the risk has this characteristic, then it is therefore good.*

Political risks violate a majority, if not all, of the assumptions that underlie statistical/actuarial pricing models in insurance. Political risk exposure units are not homogeneous, that is, the frequency of a loss and severity of a loss are idiosyncratic for every insured. In addition, the political risk loss event in some cases is not definite or objective. In other words, it is not clear if the host government’s actions or inactions were deliberately targeted towards a particular insured or if it affected every investor in the host country, e.g. was it a non-discriminatory act and, if not, was this loss covered and should the PRI provider be considered liable for that loss. This issue is best illustrated in the political risk broker’s words:

Participant 12: *And they [host governments] tended to take actions which were slightly diseased, sometimes called creeping expropriation. And that does not take the same form in any country at any time. So that is one of the reasons why it is quite difficult for the investment insurance product to be as clear-cut as say default product. But people continue to find ways of dealing with that.*

The inadequacies of statistical information makes the forecasting of PRI claims a challenging task, which can in turn be susceptible to large errors. However, there are a number of other sources of information available to the political risk underwriter that he or she can take into account in the pricing process. Most of this information is contained in, or appended to, the “slip” which is the document on which an underwriter may subscribe for part or all of a risk. The information on the slip usually includes a history of past losses (if any). The amount of information available on any individual risk varies, however, grounded theory analysis has identified the following, non-exhaustive, list of
information that is taken into consideration in the ratemaking process: client, location of a risk, class of business insured, limit desired by the client, recovery option and tenor. The other relevant information in the PRI pricing is compiled from *general market knowledge* and includes credit default swap (CDS) pricing, sovereign bond pricing and commodity pricing (see Table 4.1).

The role of the ‘*slip*’ and ‘*general market knowledge*’ information in the determination of the premium rate can be difficult to quantify and define. However, grounded theory analysis can provide some basis for theorising on the pricing of PRI contracts in respect of each individual element of information. The findings presented in this section provide new insights into the area of PRI pricing, as well as contribute to the transparency of a subject which, to date, has received little attention from academics and regulators alike. The impact of the individual elements of information from the *slip* can be summarised as follows:

- **Client** - an applicant for the PRI with a strong financial position and with experience in trading with or investing in overseas markets is considered to be a lower risk and consequently would be subject to a lower premium. Financial status and experience implies that an applicant would be better equipped to deal with issues arising from the host government’s actions or inactions.

- **Location of a risk** - some host counties are perceived as capacity risks by PRI market participants and therefore would be charged a higher premium. At the time of research interview, Russia, Turkey, and China were identified as a capacity risks by the political risk broker. Generally, a country and/or region that is assumed to be politically unstable or where the PRI market has experienced an extensive loss is perceived to belong to a category of higher risk.

- **Class of business insured** - different classes of business involve different levels of political risk. Some industries and sectors attract more attention from the governments and are monitored by the governing authorities on a day-to-day basis. Industries that are perceived to be strategically important by the host government tend to be more heavily regulated and supervised in comparison
### Table 4.1: Information for ratemaking

#### Panel A: “Slip” Information

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<thead>
<tr>
<th>Factors</th>
<th>Field data from interview notes: examples</th>
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<tbody>
<tr>
<td><strong>Client</strong></td>
<td>Participant 10: There are obligors in certain countries that are capacity risks and they always have been and they probably always be. So you automatically know that. You know there if there is a big pre-export finance coming into the market and you are seeing that risk from 5/6 different banks. That you probably guessed other people in market are picking up the same. And therefore, that becomes a capacity issue.</td>
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<tr>
<td><strong>Location of a risk</strong></td>
<td>Participant 8: Location is the main one and probably the second is what the client actually does.</td>
</tr>
<tr>
<td><strong>Class of business insured</strong></td>
<td>Participant 6: In terms of pure political risk side... Obviously, if you are coming from the lender’s point of view rather then equity, you are broadly in a better position. Because it is more contingent, more distant, you’re sort of removed from the small problems, you are only exposed to the big problems. So simplistically covering debt is better than covering equity.</td>
</tr>
<tr>
<td><strong>Limit desired by the client</strong></td>
<td>Participant 7: The key for us is about having a balance. How much business we write? That is our income $100m; the most that we write on any client is that $100m; and our accumulation zone is that $200m. So actually, that sort of ratio works well.</td>
</tr>
<tr>
<td><strong>Recovery option</strong></td>
<td>Participant 5: Again, the underwriting is not just about the risk of something happening. If it does happen, does the documentation, the structure of a deal, give you a recovery option? Because that recovery option will affect the pricing. If you have no recovery option, you have to charge a higher price than if you had a recovery option.</td>
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<tr>
<td><strong>Tenor</strong></td>
<td>Participant 3: You know you write for 8-year periods and it is very hard to manage that kind of exposure. We have a maximum of PR 10 years or 5 years. But my personal opinion, giving the economic cycle you don’t want to be writing more than 5 years. 3 years ideally.</td>
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#### Panel B: General Market Information

<table>
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<tr>
<th>Factors</th>
<th>Field data from interview notes: examples</th>
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<tbody>
<tr>
<td><strong>Credit Default Swap (CDS) pricing</strong></td>
<td>Participant 1: I suppose a good way of benchmark for how stable the place is CDS price. So, you look at CDS in Ukraine at the moment and – I don’t know what it is – but I expect it is 20% something like that. This would suggest to me that if someone proposes a sovereign default coverage paying 3% I might not want to do that.</td>
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<td><strong>Sovereign bond pricing</strong></td>
<td>Participant 12: If you are looking at a non-payment risk of certain country, you have always make an allowance that we sell insurance product not a financial guarantee. Once you’ve done that you got sovereign bonds, you have whole host of things to benchmark to.</td>
</tr>
<tr>
<td><strong>Commodity pricing</strong></td>
<td>Participant 11: This happens all the time with the rise and fall of the commodity prices. When the commodity prices reached their peak there was a lot of resource nationalism, which was basically government saying “hang on a minute these investors got plenty of a deal, we want to change that deal”. Embargo is the other thing. For example, the purpose of some big tax changes in the mining sector in Zambia, which is gone now because the prices have gone down. So they want foreign investors when they need their money but as soon as they start making money that can change.</td>
</tr>
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</table>
with sectors and industries which are of no strategic importance to the host country. According to grounded theory analysis, underwriters perceive a class of business to be a higher risk if it operates in a sector that is seen as vital or strategically important to the host country, such as power and extractive sectors.

- **Limit desired by the client** – when an insurance firm accepts a risk, it has to commit a part of its capital in order to hold sufficient liquid funds to meet future claims. PRI providers have a limited capacity which they try to allocate in the most effective and efficient way. The larger the limit desired by the client, the less capacity a PRI provider retains, which in turns impacts on the future options available to it. In other words, the larger the limit, the greater the commitment from the PRI provider’s point of view, thus the higher the premium.

- **Recovery option** – the attachment of a recovery option to the PRI policy would lower a premium price for an insured. In the case of loss, a PRI provider would pay out a claim to a client. However, a recovery option allows the insurer to redeem a part or all of the value of the claim paid out from the host government if the international arbitration tribunal declares that the host country breached a foreign investor’s rights.

- **Tenor** - tenor is a positively priced commodity in the private PRI market, whereby the longer the policy period, the higher the premium. That is due to the time value of money and the uncertainty surrounding political risk.

In addition to the ‘slip’ information, political risk underwriters gather the general market knowledge from a number of sources, such as news, rating and intelligence agencies, industry briefings, as well as from capital markets, e.g. an underwriter would look at the CDS pricing of a particular sovereign bond as an indication of risk level or stability measure. The rationale behind the usage of general market knowledge for ratemaking is explained as follows:

- **CDS pricing** – CDS prices on sovereign bonds are used as a stability measure with high CDS price volatility implying higher political uncertainty. Financial, economic, socio-cultural and political factors are taken into account in CDS pricing. Perception and speculation on the part of investor have a role to pay in it
as well. According to grounded theory analysis, the PRI market uses CDS pricing as a proxy measure of country risk stability. Unlike sovereign bond ratings, CDS prices constantly move to reflect current market conditions.

- **Sovereign Bond ratings** – political risk underwriters utilize sovereign bond ratings comparatively in order to assign countries into different risk categories with countries with the same sovereign credit risk rating falling into one category. The lower the rating grade, the higher the risk. However, while sovereign bond ratings can tell a lot about a government’s non-payment risk, they are of limited explanatory power when it comes to pricing the pure political risks, e.g. confiscation, expropriation and nationalization.

- **Commodity pricing** – it is generally accepted that one of the key drivers of expropriation risk for foreign companies’ investments are derived from political ideology (Agarwal and Feils, 2007; Bunn and Mustafaoğlu, 978). Study participants argued that other factors, e.g. commodity prices can also steer the risk of expropriation for foreign investors. High commodity prices can trigger political risk in two principal channels. Firstly, for example, the host government might begin to regret giving the concession to extract natural resources away too cheaply, which in turn can result in the government renegotiating the contract specifics with a foreign investor. Secondly, rising commodity prices generally lead to an increase in food and energy prices, and in turn to the escalation of political risks such as political violence and expropriation. For instance, the host government might be under pressure to keep food prices down or fixed in order to avoid civil unrest. This pressure can result in political protectionism acts and/or confiscations of imported food stocks in order to keep food in the country.

The data from the research interviews were grouped together under the thematic headings which allowed the identification of the main information sources outlined above, which are utilized by political risk underwriters. This non-exhaustive list of information sources was common to the majority of study participants. Other sources of information were not included in the analysis, as they were individual-specific rather than generic to the PRI market. Overall, some information elements are more significant and others more superficial in relation to the pricing question, with the impact of the
different information elements differing from one risk to another. It is obvious that to take all relevant information into account in a political risk rating formula would prove an extremely complex task. It would also be difficult to provide a complete set of objective elements for a formula, since many of the listed items are essentially matters that require human judgement.

4.4.3. The Financial Economic Approach

Both catastrophe market practitioners and academics have been trying to answer the basic question “how much should be charged for contract acceptance?” for decades (Ayling, 1984; Cummins, 1991; Dong, Shah and Wong, 1996; Wang, 2000). However, there is no universally agreed pricing solution for catastrophe insurance. According to the grounded theory analysis, political risk underwriters resort to the financial economic approach and the rational approach to pricing in order to arrive at a premium rate which is acceptable to both client and underwriter. This is in line with the existing PRI literature (see e.g., Palmer, 2009; Coppola, 2009; Sundberg, et al, 2009; Ascari, 2010; and Rolfini and Paciotti, 2010). In some cases, a combined approach to pricing is adopted where both the financial economic approach and the rational approach are incorporated into the pricing of specific deals. A transaction takes place only if the parties involved think they benefit from the contract acceptance which is based on basic economic law. As mentioned earlier, non-life actuarial rating methods are largely unused in the UK PRI market, due to the fact that the actuarial approach requires a plentiful claim experience, as well as requiring the insureds and the applicants for insurance to be somewhat homogeneous. The PRI business does not meet this description.

PRI providers exist as a method of dealing with political risks, as well as providing consultancy services related to the management of these risks. Political risk phenomenon is linked into financial markets and the overall economy more than other types of insurance such as property and liability or terrorism risk. PRI premiums are mainly determined by the complex set of supply and demand relationships. As a lead political risk broker explained:
Participant 9: The market does use rating models, statistical models, etc. But the big picture stuff is still what goes into those models. They are really more comparative, consistency-making models... Ultimately in political risk market the rating is set by sense based on the experience of the market of what they think it is. But the real determinant of the prices, at the end of the day, is supply and demand. And it sounds there are more things to say, but this is how the market works. Supply and demand is obviously affected by lots of individual decisions, but it is still supply and demand. And it is not actuarially based. The underwriters have a fairly good idea when they think the pricing is too low and they may even think it is so low that they don’t want to write at that price. And they certainly have a good idea when the pricing is too high - the buyers don’t want to buy at that price. But the rest of it is just supply and demand.

Supply and demand dynamics are influenced by different interlocking factors. The UK PRI market is a niche market where a small number of insurers compete with each other to attract new business and to sustain ‘old’ business. According to the data analysis, PRI supply and demand dynamics are mainly driven by capacity. Palmer (2009) argues that capacity is the single largest factor contributing to the private PRI market pricing volatility. For example, if there are a number of PRI providers that have available capacity and who are willing to commit it to the same risk, this tends to push the price down and vice versa. In other words, premiums reflect the level of competition among insurers. This can also be related to underwriting cycles where the market goes through a gradual transition from the “soft market” phase, in which insurers cut their premiums in order to sustain existing business and/or to attract new business, to the “hard market” phase in which insurers increase their premiums usually preceding a large catastrophe, e.g. the Argentine crisis in 2001. In addition, Steele (1984) argues that insurers might be able to tolerate lower premiums if the difference can be compensated through the increase in investment income resulting from higher interest rates. However, there is a danger that premium rates can fall below the tolerable level as the result of “softening” market conditions, which in turn can threaten the insurer’s solvency and stability. Consider the following:

Participant 7: The relationship between price and risk is getting a bit detached. Our challenge at the moment is to make sure that we are getting the right price for the risk. Which might sound - surely that is fundamental, but it is more difficult than it has ever been.
Participant 4: *There might be more people coming into the market. The problem with that in the specialist area is if you start getting more and more new capacity in the market, the price starts tumbling down.*

Participant 11: *It does operate as a proper insurance market and like any other market becomes more or less competitive, depending on how much capacity there is.*

This finding is in line with Stone’s (1973) argument that capacity, when correctly defined, can be viewed as a positively priced commodity in the insurance of catastrophe risks. The risks associated with extremely high standard deviations or unpredictability are known as capacity risks. These risks increase the aggregate exposure ratio of a portfolio of risks and in turn consume greater amounts of the insurer’s capacity. The exposure ratio is defined as the relation of the standard deviation of an expected loss to the mean value of the loss. Conversely, the risks that are associated with the lower standard deviation, hence more predictable risks, can lower the collective exposure ratio of the portfolio. In other words, risks that have the higher standard deviation should be priced at a higher rate, as compared to risks that have the lower standard deviation. This is due to the fact that losses arising from risks associated with the lower standard deviation are more predictable and in turn consume less of the insurer’s capacity. Stone (1973) concludes that capacity risks can be priced substantially higher than they would be if a pure economic pricing model, which only takes into account long-run rates of return and ignores risk-aversion and operational constraints like survival and stability, was employed. Alternatively, the risks which create capacity should be underwritten at a lower premium than derived by economic pricing if capacity is viewed as a positively priced commodity. This trend can be also observed in the UK PRI market, where capacity risks are charged a substantially higher premium due to the implication they have for a firm’s survival and stability.

There are a number of financial theories involved in the pricing of PRI contracts like risk/reward and portfolio theory. Most underwriting decisions are made with a view to gaining a desirable return when judging it against the level of risk to be accepted by the insurance firm. There is a degree of subjectivity involved in assessing the risk/reward relationship. When an underwriter was asked about his pricing decree, he explained:
Participant 2: The market might tell you that the price for writing an oil rig in Afghanistan is 3.5% and 4%. You might look at this and say well that’s not enough money for me to make me want to write that risk. I don’t feel that I want my capital to be exposed for that risk. I don’t think it is the right level of return for my exposure.

In general, different PRI providers have varying degrees of risk tolerance and it may make sense for them to charge different rates. Risk tolerance is a function of financial capacity, insurer’s willingness to take risks and an overall profile of its business (Bennett, 2004). Thus, if a PRI insurer has a high degree of risk tolerance, it may be able to accept a lower premium; and conversely if an insurer has low risk tolerance it would not be able to accept a capacity risk, or would require a higher premium to support stability and survival constraints. Also there is a relationship between insurer’s risk tolerance and appetite levels. For example, if an insurer has a high degree of risk tolerance but a low level of risk appetite for a particular type of risks, it might decide to reject a risk of that type or charge a considerably higher premium instead. From the grounded theory analysis, it became apparent that political risk underwriters exercise two main methods in measuring the relative relationship between risk and reward. The most popular method employed in the UK PRI market is to use the sovereign credit rating system as a mean to gauge risk/reward relationship. Study participants refer to it as a benchmarking and/or consistency making system. By and large, PRI providers gather information from a number of rating and intelligence agencies on country-specific factors to assess the level of risk. Sovereign bond ratings are then used as the criteria to separate countries into different risk categories, where low sovereign creditworthiness indicates higher risk and that a risk in that country should be charged a higher premium in comparison with a risk located in the host country which has a relatively strong creditworthiness. This method is used as the benchmark for setting relative rates for different risk in different countries; however, it is not a set pricing formula for PRI policies, rather it provides underwriters with the country rating bands. PR underwriters often apply this method to guide their pricing and to make sure that they are consistent in their pricing decisions. The trend towards more transparent pricing in the London PRI market is a recent phenomenon, as most pricing in the 1980s and 1990s was done using a rational approach to pricing, i.e. based on a personal underwriter’s judgement. This new trend could be due to the new Solvency II regulation requirements that ask for quantitative risk assessments and transparency. The following
is a good example; one of the companies interviewed for the purpose of this study underwent a structural change, whereby the senior PR underwriters had to be replaced by new underwriters due to the movement within the workplace. This is what a junior underwriter said when he was asked about how he priced and selected the risks:

Participant 3: *And it became clear that there were no rules or framework for us to know what was acceptable or not acceptable between the coverage and the price...* because it has always been very subjective and you’ve always sort of said “do I like it”, instead of real control type. The only way that we could see framework for us and look at a risk and say that is acceptable and that is not acceptable or somehow collate everything. There are a lot of credit agencies out there - who is the best? And they all have fallen down over the last year anyway. So what I have done, I took 3 credit rating agencies, AIG’s internal database and we have something like political risk intelligence agency, so took their ratings as well. I combined that into the matrix where it is all averaged out to give you some uniform rate... So we scale from 1 to 10, where 1 being good and 10 being bad. We blended it. So you pull up the country and it tells you where it is on the 1 to 10 bar chart.

As it can be seen from the extract above, the PRI providers do, to an extent, use sovereign credit ratings to gauge the risk/reward relationship, i.e. to determine the rating band of country risk. However, study participants were also critical about relying too heavily on credit rating agencies’ ratings, as they had been proven wrong in the past. To overcome this problem, underwriters compare a number of different rating agencies’ ratings which can then be built into PRI pricing models. Consider the following:

Participant 10: *On their ratings? Well they were proved to be wrong haven’t they? We take their generic default data, over the periods of time. And we use that as a foundation of our pricing models. So from that point of view, but that is tested against what more than one agency does. So we have comfort in that. Default rates over time don’t move that much. Any individual one can obviously prompt evil.*

Sovereign credit ratings can provide good insight into a country’s creditworthiness and overall economic situation. However, it is very generic information and in most cases is of limited benefit to the political risk underwriters when it comes to pricing specific PRI applications. Moreover, the ratings do not move much over time and can lag behind real time information. For these reasons, the ratings fulfil more of a comparative function in pricing where they are employed to lay broad country rating bands. Grounded theory
analysis results also suggest that sovereign credit ratings can be used to measure the overall riskiness of the PRI portfolio.

The other common benchmark employed is sovereign credit default swap (CDS) premiums in the PRI market. CDS is a derivative that allows one party to purchase protection from another party against the risk that a third party will default on its payment (Tolk, 2000). CDS pricing is quantitatively based using parameters such as the likelihood of default and the recovery rate, but it also takes into account liquidity and regulatory and market sentiment about the credit. As CDS are traded in the open market, their price is ultimately the capital market’s view on whether the sovereign borrower is likely to default on its obligations. The CDS prices that result in the market place represent an average of all investors’ expectations. Arguably there are a few similarities between CDS and PRI products, so it allows political risk underwriters to compare their pricing, say, on government’s non-payment policies, to those of CDS prices on that particular sovereign; which should be closely related. PR underwriters incorporate CDS pricing in their pricing models in two ways. Firstly, CDS spreads can be used to measure the host country’s stability. In other words, the more volatile CDS spreads are, the more uncertainty there is in that particular country, which in turn would indicate that the country of interest is a higher risk. The second use of CDS prices is that it helps to establish a benchmark rate for government non-payment risks. A number of study participants expressed that they used CDS prices as a benchmark for pricing. Consider the following:

**Participant 1:** *Well based on comparable countries, comparable risks, in similar industries, certainly based on CDS price guide. CDS is like a benchmark for most of our pricing.*

According to the data analysis, the pricing of the PRI contracts is also guided by financial theories such as an internal rate of return (IRR), the net present value (NPV), and portfolio theory. Equally, Cummins’s (1990) states that insurance underwriting and pricing decision can be viewed as a corporate budgeting judgment, where underwriters accept or reject applications for insurance based on the NPV or IRR rules. From the data analysis, it has emerged that political risk underwriters indirectly employing the IRR method for pricing the PRI products. The IRR method states that only projects that have a rate of return higher or equal to the opportunity cost of capital should be underwritten.
Private PRI providers are leveraged corporations with debt and equity capital that are expected to provide the required return to their equity and debt holders. In the case of PRI underwriting the IRR is set at the cost of capital level and is used as a benchmark for pricing. As one political risk analyst explained:

Participant 4: *I think what we can do and what we try to do is to look from the very top down to our portfolio and say what the perfect portfolio looks like. And in terms of company’s appetite for risk and the risk to company’s balance sheet and our reputation and to our shareholders. What is the perfect spread of risk for us? And, you know, you set that as a benchmark and then you are not going to bang on it, but you use that as a starting point. That is the idea. And in the ideal world we think that would give us you know the right spread of risk so that we are getting the right return on our capital, our shareholders’ money.*

Grounded theory analysis suggests that there are a number of alternative financial pricing models employed in the UK PRI market. Political risk underwriters are using benchmark pricing systems to guide their pricing decisions, which are usually based on internal country ratings or credit rating agencies’ ratings and/or sovereign CDS pricing. The other financial method employed in the UK PRI market is loosely based on the IRR rule, which helps political risk underwriters to establish a minimum price/floor price for their capacity. In addition, the price of PRI products also depends on the degree of competition in the sector, with a high level of competition pushing PRI premiums downwards and visa versa. The optimal price for PRI products is determined by both expected costs and competitive constraints. However, in some cases, the financial economic pricing models are not rich enough to deal with complex risks, and so PRI providers have to resort to either the rational approach to pricing or the combined approach which are outlined in the subsequent sections. This is the first study ever to explore the pricing process within the UK PRI market. The findings outlined above provide new knowledge and insight into PRI contract pricing methods, i.e. provides some transparency to the field of risk and insurance that has been largely overlooked by academics and regulators alike.

### 4.4.4 The Rational Approach

PRI business falls under the umbrella of catastrophe insurance with political risk belonging to the category of man-made catastrophes. Dong, Shah and Wong (1996)
argue that catastrophe risks meet three criteria. Firstly, catastrophe events are low-frequency-high-severity events and have the potential to leave a large ‘footprint’ in terms of aftermath costs. Secondly, rare occurrences drive volatility, which is aggravated by the absence of precedence, which in turn contributes to the ambiguity of risk. Lastly, catastrophe events do not occur often enough to establish a record in the actuarial sense. Political risk meets all the above criteria. In the process of ratemaking for catastrophe cover, the parties involved cannot claim to fully understand the true nature of the underlying risk situation (Ayling, 1984). As a result, pricing decisions in catastrophe insurance are largely characterised by a high degree of human judgement and bargaining. A phenomenon of political risk has not escaped analysis of a risk-theoretic nature where the intention has been to identify conceptual premium components and then develop methods for their calculation. However, the UK PRI market has not yet found the practical application for the risk-theoretical approach to pricing in order to replace tacit underwriting skills and judgement. This is best illustrated by the political risk underwriter’s words:

Participant 5: Most of our pricing is what I would call relativistic pricing. It is not absolute pricing. Because to have absolute pricing, you need to have actuarial data. And there is no actuarial data. So as a result, most of what we do is relativistic. It is relative to what deals we did before and has the risk improved or deteriorated since. It can be linked to things like: what is the sovereign bond is trading at? That sort of thing. But it is fundamentally a relativistic pricing model for us, rather than absolute one.

According to the data analysis, political risk underwriters resort to the rational approach to pricing where adequate information for a more scientific approach is not available. When a senior political risk broker was asked how the UK PRI market calculates rates for political risks, he explained:

Participant 9: But when the underwriter says that [gives a rate], what is it based on? Their experience, their intuition, their knowledge, what that risk historically paid. Their judgement about: `well okay that is the same as last year, but it is the worst risk.` Now, ours is not the only market that operates like that. For the whole area of large and complex risks, a lot of rating is not actuarial based. The example I always use is, you know, the first time they’ve put oil rigs in the North Sea which was in the 70s. That was all underwritten in the wholesale market for large and complex risks. What was the right rate? Who knows? So eventually, the underwriter says `well I’ll do it for 3% and we’ll see how it goes` and client agrees to pay 3% and that is the rate.
Judgement is employed in the pricing of every PRI contract, even in the decision whether or not to use a financial economic pricing approach if one is available. There exists in the marketplace a number of rule-of-thumb pricing methods which political risk underwriters employ in pricing particular political risks. The main methods that emerged from the data analysis are as follows: trial and error, market rate, burning cost and the percentage of bank’s margin. As can be seen from the interview extract above, one of the most common methods is to try to guesstimate a rate when faced with a unique risk which has not been underwritten in the PRI market before. The other method mentioned was the market rate where a rate is calculated from the claims experience of sample of similar contracts. For example, an underwriter would assess how many similar losses, for a similar type of risk in a given country, the market, or he/she had over 10, 20 or 30 years, and then calculate the comparative frequency of a loss event, which in turn can be used in the ratemaking process. Consider the following:

Participant 12: Over the period of time rates have sort of become established for different classes, for different risks, different categories of country risk. And so different underwriters will try to get say 20 countries and try to look at what would be the price if they priced them individually and then what would be kind of global price. There is not a lot of science in that. The tendency is sort of look at a lump sum that would reflect a probability of a loss over 10/20/30 year period.

The shortcoming of the market rate method is that the losses on PRI policies are too rare to be able to establish a record in the actuarial sense. Underwriters are very much aware that the probability derived using this method is not very specific and that a considerable degree of uncertainty in the probability and the size of the loss remain. Kunreuther et al, (1995) carried out a survey of 896 underwriters in 190 randomly chosen insurance companies and showed that, for a highly ambiguous risk, underwriters would charge a much higher premium as compared to a risk where the probability is well established and the outcomes are known. It could be the case as with the excess of loss reinsurance, that PRI underwriters include a notional charge in the premium, which is called “risk loading”, to limit the potential difficulties arising from large claims. Benktander (1971) was the first to introduce the concept of risk loading with regards the reinsurer’s profit, where he argued that profit can be seen as the reward which the reinsurer should receive for agreeing to carry part of the fluctuations in gross results of
the ceding company. Therefore, reinsurer’s profit, or rather expectation of profit, is the price of carrying variance in addition to the expected average price less costs. For the most part, risk loading is the notional concept where no specific calculation exists; that is, in most cases, an underwriter’s call (Ayling, 1984).

The third method to emerge from the grounded theory analysis can be referred to as the burning cost. This term is borrowed from Ayling’s (1984) study, which analysed catastrophe underwriters’ decision-making process under uncertainty and expressed the burning cost as the claims to premiums ratio and multiplied it by 10/7. This method would only work for the working layers of excess of loss insurance that have an established record of claims experience. The generated rate would roughly correspond to the “expected value plus a loading”. In the UK PRI market, the burning cost is calculated as the ratio of maximum probable loss (MPL) in any one accumulation zone to premium income which then guides an underwriter’s pricing decision. As one underwriter explained:

Participant 7: That is our income - $100 million; the most that we write on any client is that - $100 million; and our accumulation zone is that - $200 million. So actually, that sort of ratio works well. If all of a sudden that goes to $10 million [refers to the premium income] and we still have a $100 million line. Say prices go down a lot but I still have a $100 million line and a $200 million zone. That does not make sense in the event of something happening. In the event of something happening here - $200 million event - I think we will get paid in two years [$100 million x 2 years]. By that, I mean, I write a $200 million cheque to someone or group of companies and in two years time I’ll be able to cancel that out. If premiums are that low [$10 million]... That is 20 years worth of premiums. It is just not worth doing.

As can be seen from the interview extract above, the underwriters seek to maintain balance between the risk and reward. A mismatch between the current level of exposure and premiums received can lead to insolvency in a worst-case scenario. Political risk underwriters have to make sure that their pricing methods are in line with their survival and stability constraints.

The percentage of bank’s margin approach to pricing is very common for non-payment insurance products and is widely used in the UK PRI market. All study participants from the underwriting side admitted to its use as their main pricing method or at least had used it previously to price non-payment risk. As a general rule, underwriters said they would ask for 70% to 80% of bank’s margin for a risk to be accepted. The rationale
behind this pricing method is that underwriters said they were only second underwriting the bank’s decision. Banks are experts in credit risk pricing and would not issue credit if they did not think that a borrower was able to pay it back. For this reason, underwriters are more focused on the bank’s ability to price sovereign risk than the risk itself. The downside of this pricing method that it is only applicable to non-payment risks. Consider the following:

Participant 13: Well, for non-payment risk, we price it as a percentage of the loan margin that banks are getting. So banks’ loan margin, they have two figures the cost of funds, their cost of borrowing money, and the risk margin they put on top of that, which is like a premium. So if the bank is charging 4% then we want a percentage of that 4% for the risk. And we will take the view if normally we take 80% of that number. We would then decide whether we believe 80% bearing of that risk is actually a good return for us. And that is not very difficult thing to do.

By the mechanics of the PRI contract placement procedure, the spread of risk ensures a means of sharing not only losses but also under-and-over pricing. An average rate on the PRI portfolio should ideally satisfy both stability and survival constraints, as well as meeting profit objective. No claim is made here that the market pricing methods discussed above are the only methods employed by the PRI market or that they are universal. However, this section provides new insights into the pricing techniques being employed in the UK PRI market.

4.4.5 The Combined Approach

The third approach to pricing, as identified by grounded theory analysis, is the combined approach. This method incorporates both elements of the financial economic approach and the rational approach to pricing. In other words, an underwriter might derive the rate using the financial economic approach and then using the rational approach and then compare the two rates which can be then be used as the upper and the lower boundaries to pricing for that particular risk. Ultimately, an underwriter’s decision is guided by the survival and stability constraints as well as the profit objective. The role of political risk underwriter does not differ much from the financial manager’s role, which is to maximize the shareholder value. When a senior underwriter was asked about his pricing philosophy, he explained:

Participant 2: On one level, it is market economics at its purest and, on another is what I actually think is the right level of return for my exposure <…> There is
always that combination between what you think is scientifically the right price and you can look at all sorts of indexes. You can look at risk weighing ratings, they will have lots of models thrown and that will give you something. But ultimately, there is that other part of a brain where you almost need to engage and it is the same with all sorts of insurance. Fundamentally, do I think it is worthy? The hard side of that equation... Say it is just a gamble... Nothing more then the maverick decision-making process. It is the element of both. I don’t think you can have... One on its own is bad, but it is equally bad if you only rely on the technical prices, and equally bad if you only rely on market prices. The good underwriter uses both.

The combined approach to pricing is only suitable for political risk that could be priced using both the financial economic and the rational approaches to pricing. The financial economic and the rational approaches, once combined, complement each other and, arguably, give a more accurate representation of a true level of risk. However, if the political risk of interest is unique, in other words, where the financial economic approach to pricing is not available, an underwriter has to rely solely on his/her judgement and expertise to come up with the adequate rate. The other reason why underwriters employ this hybrid method is due to the nature of political risk where political profiles of host countries can vary significantly from one country to another. Political risk event triggers can be very specific and unique to each country and they can change over time as a result of a change in ruling power, for example. By introducing the political risk underwriter’s judgement into pricing, one is making sure that a rate reflects a level of political risk as well as current market conditions. In the words of a senior risk analyst:

Participant 4: *And the fact is, when there is one model fitting 160 countries that we run through it its not going be perfect for every risk. So you still have to have a human being, an analyst interpreting what’s coming out of that model and adjusting to the specific circumstance of a country to make sure we’re accurately relaying on model’s estimates in those circumstances. And at the end of the day it’s still a human decision. <...> Just because model generated E rating that does not mean that we won’t write anything in that particular country... A lot of human judgement is involved.*

Overall, PRI contract pricing is guided by general insurance laws, i.e. the pricing principles of equity, reasonableness and adequateness. Once the risk has been introduced to the insurer, it needs to decide how much coverage to offer and what premium to charge so that it would still be able to earn a reasonable profit while not exposing itself to a catastrophic loss (Kunreuther, 2002). Insurance is no different to any
other business activity and, therefore, is affected by economic laws. Almost all central insurance practices, operations, and regulations link to economics (Black and Skipper, 2000). This is the first study known to explore the different approaches to pricing employed in the PRI market. It is believed that the insights gained through the primary grounded theory analysis enable better understanding of the pricing principles that underpin PRI. Grounded theory analysis suggests that the central rationales underpinning the different methods of PRI contract pricing are stability and survival.

4.4.6 Summary

The UK PRI market employs three main approaches to pricing which are financial economic, rational and combined methods. The non-life actuarial rating methods are largely not used in the market as they are ill-suited for the political risk exposures. Despite the fact that the manner of the PRI contract pricing methods differ from the mainstream actuarial pricing methods, they still comply with the general principles of insurance pricing. In other words, the rate to be charged for PRI coverage has to satisfy the principles of equity, adequateness and reasonableness. It is a political risk underwriter’s decision which pricing approach to adopt and hers/his choice of pricing methods can vary from one risk to another. The underwriter’s decision will be influenced to a high degree by the amount of information available to her/him for a particular risk. Overall, this section contributes new body of knowledge into the area of PRI pricing and outlines some methods used by the UK PRI market which are not employed in other insurance markets (e.g., property and liability or life insurance). This is the first study known to do a primary research on the PRI contract pricing methods in the UK insurance market.

4.5 Conclusion

To conclude this chapter, the grounded theory analysis techniques were used to analyse the primary data collected in the UK PRI market in 2009-2010. This methodology has not been used in the field of PRI prior to this study. It is pioneering work which
contributes substantial insights and new literature to under-researched area of risk and insurance.

A number of categories and concepts emerged from the data under examination (see figure 4.1). The first category of Portfolio Management explores how PRI providers manage their books of business. According to the grounded theory analysis, portfolio management can be sub-divided into three activities: setting portfolio objectives and constraints, developing underwriting strategy, and monitoring and controlling portfolio performance. Where the stability and survival constraints play an important role, not just in a portfolio management process, but also in the risk selection and pricing functions. In other words, an underwriting decision cannot threaten an insurer’s survival or stability, which is the overriding underwriter’s responsibility. Findings presented in the portfolio management section reveal techniques that are employed in specialist insurance markets to manage large and complex risks.

The second category of Risk Selection describes the criteria political risk underwriters use for selecting risks for their portfolios of political risks. The discovery made in this section is that political risk underwriters use a two-layer risk selection model, which helps them to manage problems arising from adverse selection and moral hazard. Political risk underwriters use explicit criteria (i.e., based on tangible factors such as country, industry, client and policy properties) and implicit criteria (i.e., based on intangible/abstract factors such as heuristics, reputation, risk sharing and trust). A risk is said to be acceptable for a portfolio of risks if it is satisfies both explicit and implicit risk selection criteria. This model has not been discussed in insurance literature prior to this study.

The third category of Pricing discloses that actuarial pricing methods are largely unused in the UK PRI market. This is due to a nature of political risk which, in most cases, cannot be statistically described. Instead, political risk underwriters can use the three alternative approaches to pricing: financial economic, rational and combined methods. These pricing approaches merit further exploration, as there has been little research done in the area of large and complex risk pricing and new discoveries could be made.
In summation, this chapter provides a source of new information into the area of PRI underwriting which in turn increases the transparency of the UK PRI market. However, due to the fact that grounded theory analysis is only used for developing theories rather than testing, the propositions and concepts raised in this section have to be tested using quantitative and/or qualitative research analysis techniques in order to be able to claim their validity.
CHAPTER 5: Survey Findings

5.1 Introduction

This research uniquely examines the PRI underwriting decision-making process in the UK private insurance market. In doing so, it also makes a comparison between the UK and non-UK PRI markets. It was of interest to investigate the underwriting differences between the UK and non-UK markets, as this can give an indication whether the placing of a political risk in an insurance market and the cost of doing it can be affected by cultural and/or regulatory differences. The distinctiveness of the UK PRI market decision-making can also suggest that PRI underwriting approach can vary from one insurance market to another. The grounded theory analysis results (see Chapter 4) informed a scenario-based survey design, which helped to answer the research questions 3 to 5. The methodology is described in a Chapter 3.

The research instrument was divided into four sections, with each section further subdivided into four parts. Each section started with a hypothetical risk description, with the study participant informed that he or she would need to make an underwriting decision regarding the risk (see Appendix D). This innovative semi-experimental approach generated primary qualitative and quantitative data which enabled the researcher to overcome an obstacle of premium data availability. Statistical analysis of the responses from the research instrument revealed that UK PRI market participants exhibit greater risk aversion than North America, EU, Asia and Africa PRI market participants. This was reflected in lower levels of risk acceptance for the UK PRI market. However, there was no strong evidence found to suggest that pricing patterns were significantly different in the five surveyed PRI jurisdictions. The findings in turn imply that it can be more difficult to place a risk in the UK PRI market than say, in the

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12 Due to the time and financial constraints it was not possible to execute the grounded theory analysis in different PRI markets in order to compare PRI underwriting mechanisms.
13 Research question 3: Which factors impact on perceptions of political risk underwriters as to what risks are acceptable? Research question 4: Does the UK PRI market have different levels of political risk acceptance as compared to other PRI markets? Research question 5: Do UK political risk underwriters price political risks differently from underwriters in other markets?
North American market; nevertheless, the cost of insuring would be similar in both markets. Future research could be conducted in the PRI field in order to explain the underlying reasons for differences in decision-making between the UK and non-UK PRI markets.

This chapter is divided into four parts. The first part outlines the profile of study participants in terms of gender, age, and education levels. Hypotheses arising from the research questions are presented in the second part, while the third part reports the findings from the present study. The third part is split into four different sub-sections where each sub-section analyses a specific scenario using the data gathered from the research instrument. The fourth part concludes the chapter.

5.2 Profile of Study Participants

The gender breakdown of the PRI experts sample is fairly uneven, with 82.6% of participants being male and 17.4% female. A similar gender balance is also observed in a control group of non-experts, with 82.8% male and 17.2% female. The distribution of study participants’ age per gender and expertise is presented in table 5.1. Age distribution is relatively disperse, with 29.81% of participants being in 25-33 age category, 31.73% in 34-42 age category, 20.19% in 43-51 age category, 16.35% in 52-60 age category. The over 60 years of age and 18-24 age categories both had one participant each (0.96% each). Out of 104 study participants, 75 participants were experienced in underwriting political risks. They had a minimum of one year of experience, with the maximum being 31 years and the mean 10 years. A comparison with the PRI practitioner population as a whole is not possible, as the profile of the population has never been mapped. The control group participants (n=29) did not have any PRI underwriting experience and were working in PRI-related fields such as export credit insurance and political risk consultancy.
Table 5.1: Distribution per age and gender of study participants (N=104 of which 75 PRI experts and 29 non-experts)

<table>
<thead>
<tr>
<th>AGE</th>
<th>N</th>
<th>% of respondents</th>
<th>GENDER</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Male</td>
<td></td>
<td>Female</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>N</td>
<td>Experts % of respondents</td>
<td>N</td>
<td>Non-experts % of respondents</td>
<td>N</td>
<td>Experts % of respondents</td>
<td>N</td>
<td>Non-experts % of respondents</td>
<td>N</td>
<td>Non-experts % of respondents</td>
</tr>
<tr>
<td>18-24</td>
<td>1</td>
<td>0.96</td>
<td>1</td>
<td>0.96</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>25-33</td>
<td>31</td>
<td>29.81</td>
<td>16</td>
<td>15.39</td>
<td>7</td>
<td>6.73</td>
<td>4</td>
<td>3.85</td>
<td>4</td>
<td>3.85</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>34-42</td>
<td>33</td>
<td>31.73</td>
<td>19</td>
<td>18.28</td>
<td>10</td>
<td>9.61</td>
<td>4</td>
<td>3.85</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>43-51</td>
<td>21</td>
<td>20.19</td>
<td>15</td>
<td>14.42</td>
<td>3</td>
<td>2.88</td>
<td>3</td>
<td>2.88</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>52-60</td>
<td>17</td>
<td>16.35</td>
<td>11</td>
<td>10.57</td>
<td>4</td>
<td>3.85</td>
<td>1</td>
<td>0.96</td>
<td>1</td>
<td>0.96</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Over 60</td>
<td>1</td>
<td>0.96</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>1</td>
<td>0.96</td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>104</td>
<td>100.00</td>
<td>62</td>
<td>59.62</td>
<td>24</td>
<td>23.07</td>
<td>13</td>
<td>12.50</td>
<td>5</td>
<td>4.81</td>
<td>-</td>
<td></td>
</tr>
</tbody>
</table>

86.67% of the surveyed PRI experts had at least a bachelor’s degree, with many having a master’s level academic qualifications (57.33 %) and 9.33% of the experts indicated their professional qualification as their highest held qualification. The majority of the control group participants had a bachelor’s degree (79.31 %) and many also had a master’s level academic qualification (37.93 %). The breakdown of education level is set out in Table 5.2.

Table 5.2: Highest level of academic qualification of study participants (N=104 of which 75 PRI experts and 29 non-experts)

<table>
<thead>
<tr>
<th>EDUCATION</th>
<th>N</th>
<th>% of respondents</th>
<th>GENDER</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Male</td>
<td></td>
<td>Female</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>N</td>
<td>Experts % of respondents</td>
<td>N</td>
<td>Non-experts % of respondents</td>
<td>N</td>
<td>Experts % of respondents</td>
<td>N</td>
<td>Non-experts % of respondents</td>
<td>N</td>
<td>Non-experts % of respondents</td>
</tr>
<tr>
<td>Secondary edu.</td>
<td>4</td>
<td>3.85</td>
<td>2</td>
<td>1.92</td>
<td>1</td>
<td>0.96</td>
<td>1</td>
<td>0.96</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Bachelor’s</td>
<td>33</td>
<td>31.73</td>
<td>15</td>
<td>14.42</td>
<td>11</td>
<td>10.57</td>
<td>6</td>
<td>5.77</td>
<td>1</td>
<td>0.96</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Master’s</td>
<td>54</td>
<td>51.92</td>
<td>37</td>
<td>34.58</td>
<td>9</td>
<td>8.65</td>
<td>6</td>
<td>5.77</td>
<td>2</td>
<td>1.92</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Doctoral</td>
<td>2</td>
<td>1.92</td>
<td>1</td>
<td>0.96</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>1</td>
<td>0.96</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Professional</td>
<td>11</td>
<td>10.58</td>
<td>7</td>
<td>6.73</td>
<td>3</td>
<td>2.88</td>
<td>-</td>
<td>-</td>
<td>1</td>
<td>0.96</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>104</td>
<td>100.00</td>
<td>62</td>
<td>58.61</td>
<td>24</td>
<td>23.06</td>
<td>13</td>
<td>12.50</td>
<td>5</td>
<td>4.80</td>
<td>-</td>
<td></td>
</tr>
</tbody>
</table>
The surveyed PRI market participants come from a number of jurisdictions, as illustrated in Figure 5.1. 34.67% of PRI experts were from UK jurisdiction, 33.33% from North America, 13.33% from EU, 12% from Asia and 6.67% from Africa. The largest group of non-experts were from the EU (34.48 per cent), the second largest group was from North America (24.14 per cent), closely followed by UK and Asia (20.69 % from each jurisdiction). There were no participants from the Africa jurisdiction in the control group.

**Figure 5.1:** Home jurisdiction of study participants (N=104 of which 75 PRI experts and 29 non-experts)

<table>
<thead>
<tr>
<th></th>
<th>PRI Expert</th>
<th>Non-Expert</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>26</td>
<td>6</td>
</tr>
<tr>
<td>North America</td>
<td>25</td>
<td>7</td>
</tr>
<tr>
<td>EU</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Asia</td>
<td>9</td>
<td>6</td>
</tr>
<tr>
<td>Africa</td>
<td>5</td>
<td>5</td>
</tr>
</tbody>
</table>

### 5.3 Hypothesis Development

The research question 3 to 5 were raised in order to address gaps in the existing literature and contribute to a better understanding of the PRI underwriting processes in the insurance market. Research question 3: which factors impact on the perceptions of political risk underwriters as to what risks are acceptable is attended by identifying which items of consideration were perceived important by the PRI expert group. An item is considered to be important if 70 per cent of the PRI expert group indicated it to be a very important or important factor in making an underwriting decision. In addition to that, the respondents’ comments from the collected surveys on the four hypothetical risk scenarios were analysed and included in the results. In order to address the research questions 4 and 5, a series of hypotheses were developed for each one so that they could be tested using the data gathered from the research instruments. Research questions 4
Research question 4: *Does the UK PRI market have different levels of political risk acceptance as compared to other PRI markets?*

Research question 4 can be addressed by examining whether there is a difference between the UK PRI market’s risk acceptance levels and those of other surveyed PRI markets and the control group. If PRI experts from UK and other jurisdictions have a similar level of risk acceptance, this indicates that there is nothing inherently different about trying to place a risk outside the UK PRI market. However, if the risk acceptance levels are significantly different, the indication may be that it is easier or more difficult to insure a political risk outside the UK private insurance sector. The use of a control group in this study facilitates the unpicking of the risk acceptance levels outside the PRI domain in a manner not done before. This leads to Hypotheses 4a and 4b.

**Hypothesis 4a:** *When considering risks for a portfolio of political risks, the UK PRI experts will have lower levels of risk acceptance in comparison to PRI experts from other jurisdictions.*

**Hypothesis 4b:** *When considering risks for a portfolio of political risks, the UK PRI experts will have lower levels of risk acceptance in comparison to the control group.*

This study also tries to explore for the first time whether or not different PRI jurisdictions differ significantly in their pricing of political risk. This leads to the next research question.

**Research question 5: *Do London political risk underwriters price political risks differently from underwriters of other markets?***

The approach taken to address the research question 5 is very similar to that of the research question 4. Pricing differences are examined between the UK and non-UK PRI markets (e.g., the North America and EU PRI markets) for the four hypothetical risk scenarios. Depending on the results to the above question, it may be inferred that the pure cost of insuring a risk in the UK PRI market is similar or different to that of other PRI markets. In addition, the use of the control group will allow this study to check...
whether there is a significant difference between how PRI experts and non-experts price political risks. Hypotheses 5a and 5b therefore state:

Hypothesis 5a: The UK PRI experts will price political risk higher in comparison to PRI experts from other jurisdictions.

Hypothesis 5b: The UK PRI experts will price political risk higher in comparison to the control group.

Table 5.3: Research questions leading to hypotheses

<table>
<thead>
<tr>
<th>Research Question</th>
<th>Hypothesis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Research question 1: How does the London PRI market select political risks for a portfolio of risks?</td>
<td>NA</td>
</tr>
<tr>
<td>Research question 2: What pricing methods does the London PRI market use?</td>
<td>NA</td>
</tr>
<tr>
<td>Research question 3: Which factors impact on perceptions of political risk underwriters as to what risks are acceptable?</td>
<td>NA</td>
</tr>
</tbody>
</table>
| Research question 4: Does the UK PRI market have different levels of political risk acceptance as compared to other PRI markets? | Hypothesis 4a: When considering risks for a portfolio of political risks, the UK PRI experts will have lower levels of risk acceptance in comparison to PRI experts from other jurisdictions.  
Hypothesis 4b: When considering risks for a portfolio of political risks, the UK PRI experts will have lower levels of risk acceptance in comparison to the control group. |
| Research question 5: Do London political risk underwriters price political risks differently from underwriters of other markets? | Hypothesis 5a: The UK PRI experts will price political risk higher in comparison to PRI experts from other jurisdictions.  
Hypothesis 5b: The UK PRI experts will price political risk higher in comparison to the control group. |

The Mann-Whitney-U test will be carried out to test the four research hypothesis. The test is appropriate in this case for three main underlying reasons. Firstly, it is a standard non-parametric test which deals with categorical data that is not normally distributed. Secondly, it is suitable for both small and large samples\(^\text{14}\) (Bajpai, 2011). Finally, it is used for samples that are independent and possibly of different sizes. This was a desired

\(^{14}\) A sample is considered to be large when \(n_1\) (number of items in sample 1) and \(n_2\) (number of items in sample 2) are both greater than 10 (Bajpai, 2011)
quality since sample sizes of the PRI markets surveyed varied widely (e.g., from 26 to 5 participants per surveyed PRI market). The next part of this chapter presents results of the scenario-based survey.

5.4 Results

The following four sections report empirical findings on the four hypothetical risk scenarios. All of the analysis outlined in this chapter has been done using SPSS software.

5.4.1 Scenario One: Indonesia Project Risk Analysis

The Indonesia project risk scenario is an example of traditional PRI exposure. In this scenario, study participants were asked if they would be willing to insure a German coal mining and production company which is considering an acquisition of a coal mining operation site worth US$300 million in Indonesia. It was also mentioned that MIGA agreed to insure US$250 million for a 2% premium rate. This scenario was chosen in order to obtain a better understanding of what factors are important when considering traditional PRI products. The willingness of private PRI markets to co-insure with multilateral PRI provider was also explored. The ten items of consideration were carefully selected in line with grounded theory results (see Chapter 4). These items were later grouped into four categories; namely, host country political factors, host country economic factors, client factors and technical factors, in order to assess if different categories had different levels of importance when making an underwriting decision (this procedure was repeated for each of the four scenarios).

The next section reports results on risk acceptance and pricing for the Indonesia risk scenario.
5.4.1.1 Indonesia Risk Acceptance and Pricing

An average level of risk acceptance for the Indonesia risk scenario was in a range between US$10 million and US$20 million. Of the PRI experts surveyed, 7 study participants (9.33 %) declined the risk. Of these 6 were from UK, while 1 was from the North America jurisdiction. In comparison, PRI market participants surveyed from EU, Asia and Africa markets all found the risk to be acceptable at different levels. Figure 5.2 illustrates the survey’s general findings on risk acceptance levels for both the PRI expert group and the control group. The Mann-Whitney U Test, which tests for differences between two groups on a single variable with no particular distribution, was carried out to test if there was a statistical difference between the UK PRI market and other PRI markets in relation to risk acceptance levels. Since the main focus of this study is the private UK PRI market only, comparisons between the UK PRI market and other markets including the control group were made. The findings are presented in Table 5.4.

Test results indicate that the UK PRI market’s acceptance levels for Indonesian risk were statistically lower from the North American PRI market at 0.01 level (p=0.005). The UK market was also statistically different from the EU PRI market and Asian PRI market at 0.05 level (p=0.019 and p = 0.025 respectively) and with a marginally significant difference from the African PRI market at 0.10 level (p=0.091). This supports hypothesis 4a. As hypothesised, the non-expert group was significantly different from the UK PRI market at 0.000 level (p=0.000), which is in line with hypothesis 4b. The control group found the risk to be acceptable with a majority of surveyed non-experts (68.9%), indicating that more than US$20 million coverage was tolerable. One possible explanation of risk aversion of the UK PRI market, which is also supported by the survey participants’ comments, is that the UK PRI market has had an extensive claims record in Indonesia. This in turn could have an impact on risk perception and acceptance. In addition to this, the grounded theory results suggest that the UK PRI market tends not to retrocede risks, which in turn can make the UK PRI market more selective. This is best illustrated by the surveyed PRI experts’ comments:

*Market experience of similar long-term coal / expropriation risks involving Indonesia has been poor* – The UK PRI market participant
There have been export issues with coal in Indonesia, so I would not offer cover. The only way would be behind MIGA, not coinsurance. Then, I would consider a small line of $5 million. – The UK PRI market participant

Figure 5.2: Indonesia risk acceptance levels.

An average rate proposed for the Indonesia risk by PRI experts was within 1.51% and 2% range. Interestingly, the control group suggested an average rate for a contract of risk acceptance between the range of 1.51% and 2%. Figure 5.3 below illustrates a distribution of proposed pricing. One third of the PRI experts said they would charge between 2.01% and 2.5% range, and a similar proportion of 30.3% of the surveyed PRI experts indicated that they would charge between 1.51% and 2% for a contract of risk acceptance. Approximately 12% of the experts said they would charge around 1.01% to 1.5% rate. Around 7% of the PRI expert group said they would price the risk at 2.5-3% level and 9.3% said the rate for the contract of acceptance should be over 3%. Only a minority of the surveyed PRI experts (8%) thought that the risk was worth between 0.51-1%. None of the participants from either the PRI expert group or the control group...
thought that a rate for the Indonesia risk should be less than 0.5%. The Mann Whitney U-test test was executed to look for statistical differences in pricing patterns among the PRI markets. The results show no statistically significant difference between all five PRI markets’ pricing included in this study (see Table 5.4). Thus, hypothesis 5a is rejected. This implies that pricing patterns for the Indonesia risk were similar in all five surveyed PRI jurisdictions, which in turn would suggest that the pure cost of placing a similar risk would be no different outside the UK PRI market. There was a statistically significant difference between the UK PRI market and the control group pricing at 0.05 (p=0.042), which supports hypothesis 5b.

**Figure 5.3:** Indonesia scenario risk pricing.
Table 5.4: Risk selection and pricing comparison between the UK PRI market and other jurisdictions including control group for Indonesia risk scenario.

<table>
<thead>
<tr>
<th>JURISDICTION</th>
<th>Risk Acceptance (LINEin)</th>
<th>Risk Pricing (RATEin)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Median</td>
<td>Differences</td>
</tr>
<tr>
<td></td>
<td></td>
<td>p-values</td>
</tr>
<tr>
<td>North American market</td>
<td>5.00</td>
<td>0.005**</td>
</tr>
<tr>
<td>EU market</td>
<td>5.00</td>
<td>0.019*</td>
</tr>
<tr>
<td>Asian market</td>
<td>5.00</td>
<td>0.025*</td>
</tr>
<tr>
<td>African market</td>
<td>5.00</td>
<td>0.091†</td>
</tr>
<tr>
<td>Control group</td>
<td>5.00</td>
<td>0.000***</td>
</tr>
</tbody>
</table>

Notes:
1. The non-parametric Mann-Whitney-U test was used to test for statistical differences for LINEin and RATEin categorical variables.
2. LINEin takes a value of 1 if participant declined a risk, 2 if accepted up to US$5 million, 3 if accepted at US$5-US$10 million level, 4 if accepted at US$10-US$20 million level, 5 if accepted at US$20-US$40 million level and 6 if accepted at more than US$40 million level.
3. RATEin takes a value of 1 if participant priced a risk up to 0.5%, 2 if priced a risk in a range of 0.51-1%, 3 if priced a risk in a range of 1.01-1.5%, 4 if priced a risk in a range of 1.51-2%, 5 if priced a risk in a range of 2.01-2.5%, 6 if priced a risk in a range of 2.5-3% range and 7 if priced a risk over 3%.
4. †Marginally significant at p<0.10, * p<0.05, ** p<0.01, *** p<0.001

5.4.1.2 Indonesia Risk Factor Analysis Results

Table 5.5 displays the survey’s general findings on the Indonesia project risk scenario on the ten items of consideration for both PRI experts and the control group. The research results revealed that surveyed PRI market participants considered facts that the risk was in the mining and extracting industry (SIXin – 90.7%), the Indonesian government’s role in the economy (ONEin - 81.3%) and that MIGA was co-insuring the risk (NINEin – 80.0%) as the most important factors. Indonesia’s membership of the WTO and the ICSID (FIVEin – 64.0%), the host country’s credit rating (EIGHTin – 63.5%), Indonesia and Germany’s bilateral relationship (FOURin – 61.3%) and GDP growth rate (THREEin – 52.1%) were of a lesser importance to the PRI expert group. Facility to retrocede a part of the risk (TENin – 48%), potential insured’s engagement in corporate social responsibility (SEVENin – 48.0%) and Indonesia’s rank in Protecting Investors (TWOin – 36.0%) were considered to be only moderately important in making an underwriting decision. There were a number of similarities between the PRI expert

15 An item was considered to be important if 70% or more of the surveyed PRI experts indicate it as important or very important factor.
group and control group. For example, the non-expert group also thought that MIGA’s participation on the risk was a very important attribute (NINEin – 89.6%). In addition, considerations such as the sector within which the risk was to be insured (SIXin - 75.9%) and the Indonesian government’s role (ONEin - 75.8%) were also important to the control group.

Furthermore, study participants were asked to give any comments they felt would be relevant in making an underwriting decision in the Indonesia risk scenario (and other risk scenarios). A number of PRI experts said that market’s claims experience was an important factor. Consider the following:

*The issue of export license cancellation in the coal sector in Indonesia is key; would need to do careful due diligence; would also want a policy sublimit for this peril. CEN coverage should be total loss only.* – The North America PRI market participant

The importance of the potential insured’s experience in foreign markets was also stressed by PRI experts. This is in line with grounded theory analysis results. As one UK PRI market participant expressed:

*Past experience of the applicant with their investment and their activity with Indonesia would be extremely important.* - The UK PRI market participant

Other factors mentioned by the PRI expert group included who was an issuer of mining licences and what was the state of project finances. Policy-specific considerations, such as whether or not the policy was covering partial expropriation loss or complete loss and if there was a deductible, appeared to play a role in making a PRI underwriting decision. A complete (or total) loss is less likely than a partial loss and therefore could be a desired clause by the underwriter, as it reduces chances of an occurrence of insured event.

Although both groups indicated that MIGA’s participation was a very important factor, the PRI expert group had some concerns over it. The research results revealed that there are a number of issues associated with co-insuring with a multilateral PRI provider. One
Table 5.5: Findings on the ten items of consideration for Indonesia risk scenario for both the PRI expert and control groups (PRI.E stands for PRI Expert group and N.E – stands for control group).

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
<th>PRI.E</th>
<th>N.E</th>
</tr>
</thead>
<tbody>
<tr>
<td>ONEin</td>
<td>Indonesia has a market-based economy in which the government plays a significant role.</td>
<td>Unimportant</td>
<td>Of little importance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>N</td>
<td>N %</td>
</tr>
<tr>
<td>PRI.E</td>
<td>0</td>
<td>0,0%</td>
<td>1</td>
</tr>
<tr>
<td>N.E</td>
<td>0</td>
<td>0,0%</td>
<td>3</td>
</tr>
<tr>
<td>TWOin: The World bank downgraded Indonesia’s rank in Protecting Investors from 41 to 44 in 2011 (out of 183 countries, 183rd rank being the worst)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PRI.E</td>
<td>2</td>
<td>2,7%</td>
<td>13</td>
</tr>
<tr>
<td>N.E</td>
<td>1</td>
<td>3,4%</td>
<td>6</td>
</tr>
<tr>
<td>THREEin: Indonesia has positive GDP growth: 4.5% (2009), 6.1% (2010) and 6.2% (2011)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PRI.E</td>
<td>0</td>
<td>0,0%</td>
<td>1</td>
</tr>
<tr>
<td>N.E</td>
<td>1</td>
<td>3,4%</td>
<td>4</td>
</tr>
<tr>
<td>FOURin: Through the ups and downs of Indonesia's economy in recent years, Germany remained its most important European trade partner.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PRI.E</td>
<td>1</td>
<td>1,3%</td>
<td>8</td>
</tr>
<tr>
<td>N.E</td>
<td>1</td>
<td>3,4%</td>
<td>2</td>
</tr>
<tr>
<td>FIVEin: Indonesia is a member of the WTO and the International Centre for Settlements of Investment Disputes (ICSID).</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PRI.E</td>
<td>0</td>
<td>0,0%</td>
<td>6</td>
</tr>
<tr>
<td>N.E</td>
<td>0</td>
<td>0,0%</td>
<td>5</td>
</tr>
<tr>
<td>SIXin: The fact that the risk is in the mining and extraction sector.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PRI.E</td>
<td>1</td>
<td>1,3%</td>
<td>0</td>
</tr>
<tr>
<td>N.E</td>
<td>0</td>
<td>0,0%</td>
<td>1</td>
</tr>
<tr>
<td>SEVENin: The potential insured engages in corporate social responsibility and is committed to contributing to the local community’s wellbeing.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PRI.E</td>
<td>3</td>
<td>4,1%</td>
<td>12</td>
</tr>
<tr>
<td>N.E</td>
<td>3</td>
<td>10,3%</td>
<td>4</td>
</tr>
<tr>
<td>EIGHTin: The host country’s credit rating</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PRI.E</td>
<td>0</td>
<td>0,0%</td>
<td>4</td>
</tr>
<tr>
<td>N.E</td>
<td>1</td>
<td>3,4%</td>
<td>5</td>
</tr>
<tr>
<td>NINEin: The fact that MIGA is co-insuring the risk</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PRI.E</td>
<td>1</td>
<td>1,3%</td>
<td>5</td>
</tr>
<tr>
<td>N.E</td>
<td>0</td>
<td>0,0%</td>
<td>3</td>
</tr>
<tr>
<td>TENin: Your facility to retrocede part of the risk</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PRI.E</td>
<td>8</td>
<td>10,7%</td>
<td>13</td>
</tr>
<tr>
<td>N.E</td>
<td>0</td>
<td>0,0%</td>
<td>3</td>
</tr>
</tbody>
</table>
of the major concerns raised by the private PRI market participants was a perceived lack of control over claims management. A number of the surveyed PRI experts noted that they would need to be able to benefit from MIGA’s Cooperative Underwriting Programme (CUP) preferred creditor status for the risk to be more acceptable. In line with this, the experts also said that claims should be shared on a *pari passu* basis. As one PRI market participant with 15 years of experience in the field explained:

> **MIGA** does not willingly coinsure with commercial insurers. It's favoured way of collaborating with the private market is to "front" and control the whole deal and use "facultative reinsurance" to provide 100% of the required limit. If a private insurer writes a direct participation in this risk alongside **MIGA**, the private insurer will not be able to conclude a claim cooperation agreement with **MIGA**. **MIGA** will not cede control of the claim to other insurers or agree to suggested changes in policy wording. **MIGA** will determine that the private insurer is not covered by the World Bank's preferred creditor status, and recoveries, although potentially available post-claim, will not be shared pro-rata (MIGA will be "first out"). – The North America PRI market participant

The general survey findings suggest that the private PRI market participants prefer to be ‘behind’ multilateral PRI providers (i.e., provide reinsurance) rather be ‘upfront’ with a multilateral provider (i.e., co-insuring a risk). This is mainly due to technical aspects such as negotiating claims arrangements, policy wordings (i.e., public PRI providers use more inclusive and broader peril definitions in comparison with private PRI providers) and recovery arrangements.

The second stage of the Indonesia risk factor analysis involved grouping the ten items of consideration into four categories. The ONEin, TWOin, FOURin and FIVEin items were put into political factor category (POLin). The THREEin and EIGHTin items were selected for economic factor category (ECOin). The SIXin and SEVENin were included into insured factor category (INSin) and the NINEin and TENin in technical factor category (TECHin). This was done in order to identify which factor categories were perceived to be the most important in making an underwriting decision. Descriptive statistics for the POLin, ECOin, INSin and TECHin for the UK PRI expert group is presented in Table 5.6. It can be seen from the analysis results that the UK PRI experts considered client-specific factors to be the most important and technical factors like co-insuring with MIGA and reinsurance agreement were of a lesser importance. Overall,
it appears that when the PRI experts surveyed were making an underwriting decision on the Indonesia risk, their main concerns were whether the potential insured had claims history and what business it was doing. They also wanted the PRI policy to have a deductible and to pay out only in the case of complete loss.

**Table 5.6:** Descriptive analysis. This table gives the descriptive statistics for the four factor categories for Indonesia risk scenario for the UK PRI market (N= 26).

<table>
<thead>
<tr>
<th>Category</th>
<th>Mean</th>
<th>Standard Deviation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Political factors category (POLin)</td>
<td>3.442</td>
<td>0.736</td>
<td>2.25</td>
<td>5.00</td>
</tr>
<tr>
<td>Economic factors category (ECOin)</td>
<td>3.808</td>
<td>0.634</td>
<td>2.50</td>
<td>5.00</td>
</tr>
<tr>
<td>Insured factor category (INSin)</td>
<td>4.039</td>
<td>0.720</td>
<td>2.50</td>
<td>5.00</td>
</tr>
<tr>
<td>Technical factors category (TECHin)</td>
<td>3.173</td>
<td>0.999</td>
<td>1.50</td>
<td>5.00</td>
</tr>
</tbody>
</table>

**5.4.2 Scenario Two: Iraq Short Term Public Payment Risk Analysis**

In this hypothetical risk scenario, study participants were asked to make an underwriting decision on an American producer and marketer of food and agricultural products. The company agreed to sell 30,524 MT of wheat of different grades, with an average price of US$352 per MT, to the Iraqi Ministry of Agriculture. The client requested coverage of US$10 million against failure to honour a letter of credit issued by the Trade Bank of Iraq on behalf of the Iraqi Ministry of Agriculture. The desired period of the policy was 90 days. This type of policy is a relatively new product in the PRI market which became popular with traders during the 1990s. It differs from the traditional PRI policies in two ways. Firstly, non-payment of letters of credit issued by a public bank product is associated with trade-related political risk; whereas traditional PRI coverage is security against expropriation, confiscation, nationalization, currency inconvertibility and political violence perils, which are considered investment-related political risk perils. Secondly, policy tenors tend to be significantly shorter (i.e. tenors can vary from 30 days up to two years in comparison with traditional PRI products where policy periods generally range from 3 years to 10 years and in special cases up to 15 years, though tenors can be longer in public PRI markets). The rationale behind this scenario was to explore what factors were perceived to be important by the PRI experts surveyed in making an underwriting decision on this type of risk.
The next section presents findings on the statistical analysis performed on data gathered from PRI experts and non-experts on the Iraq risk scenario.

### 5.4.2.1 Iraq Risk Acceptance and Pricing

An average level of risk acceptance for the Iraq risk scenario was up US$5 million for the PRI expert group, while for the control group it was closer to the US$5 million – US$10 million level (see Figure 5.4). More than one third of the PRI experts surveyed said they would decline the Iraqi risk; of which 14 were from the UK, 8 from North America, and 3 each from the EU and Asian PRI markets. Approximately a quarter of the experts suggested that they would be willing to insure this risk up to US$5 million. Another quarter of the PRI group was willing to insure between US$5 million and US$10 million. Only 5 participants (6.6%) out of 75 surveyed PRI experts chose a line between US$10 million and US$20 million. 2 PRI experts (2.6%) indicated that they would be willing to offer a line between US$20 million and US$40 million for this kind of risk and 1 PRI expert (1.3%) suggested that more than US$40 million for this type of risk would be acceptable. The results of a Mann-Whitney-U test showed that the UK PRI market was significantly more risk-averse than the North American PRI market at 0.05 level (p=0.047) and the African PRI market at 0.05 level (p=0.011) (see Table 5.7), which is in line with hypothesis 4a. The UK PRI market was only marginally different from the EU market at 0.10 level (p=0.077) and there was no significant difference found between the UK PRI market and the Asian PRI market. The control group found the risk to be significantly more acceptable in comparison with the UK market at 0.01 level (p=0.005). This finding supports hypothesis 4b. Only 6 participants from the control group declined the risk.
From analyses of the PRI experts’ comments, it appears that private PRI market participants might have a list of host countries which do and do not qualify for PRI coverage, which is in line with the grounded theory analysis results. Setting eligibility requirements is also standard practice in public PRI markets (see e.g., Rowat, 1992; Gentile and Valahu, 2004). As one participant explained his reason for declining the risk:

*We don't cover Iraq* - The UK PRI market participant

At the time of the survey, the political situation in Iraq was somewhat unstable, which could have impacted on the risk acceptance levels, and as such, made it less insurable. This also manifested itself in the comments from PRI experts surveyed in regard to the Iraq risk. Consider the following:
Would not underwrite Iraqi risk at the current time – The UK PRI market participant

Given the unsure nature of Iraq and the pullout of US forces, I would not provide risk on Iraq – The North America PRI market participant

In addition to study participants’ concerns over the uncertainty of the country situation in Iraq, one of the UK PRI market participants said that the client had a bad claims history which in turn compelled him to decline the risk. This is best illustrated by the participant’s words:

The client's track record in collecting significant claims without subsequently achieving any material recoveries undermined any prospect of my supporting them in a difficult risk – The UK PRI market participant

However, there were also a number of positive PRI expert reviews on the risk. The PRI experts surveyed revealed that the short tenor and commodity being traded were both positive aspects of the Iraq risk scenario. As one PRI expert explained:

I think this is a sound risk depending on which public bank is issuing the LC. The commodity is quite strong and the tenor is attractive, I would call this an opportunity risk. – The UK PRI market participant

Overall, it appears that unstable Iraq political situation, host country eligibility and client’s claims track record have had a negative impact on the risk acceptance levels.

Figure 5.5 PRI expert and control groups. The surveyed PRI expert group proposed an average rate between the 2.5% and 3% range and the control group suggested a range closer to 2.01% - 2.5%. Out of 75 PRI experts surveyed, 35 participants (46.7 %) said that an appropriate price for the risk acceptance was over 3%, 13 participants (17.3%) said they would charge between 2.51% and 3% and an equivalent proportion of the experts (17.3%) said that a rate should be between 2.01% and 2.5%. 7 PRI experts (9.3%) thought a rate from 1.51% to 2% was acceptable and 6 participants (8%) said they would charge between 1.01% and 1.5% for the risk acceptance. Only one PRI expert suggested charging 1.01%-1.5% for risk acceptance. The Mann-Whitney-U test
showed that the UK PRI market’s proposed rate for risk acceptance was statistically higher in comparison with the African PRI market at 0.01 level (p=0.009), which is in line with hypothesis 5a, and only marginally higher than the control group’s pricing (p=0.055). There was no statistically significant difference found between the UK PRI market and the North American, EU and Asian PRI market pricing (see table 5.7). According to the PRI expert group comments, the high rates for risk acceptance were to a large degree the result of limited country capacity. This is best illustrated in the study participant’s words:

*Limited market capacity SHOULD give rise to illogically high/opportunistic rate*

- The UK PRI market participant

This is in line with grounded theory analysis results which showed that capacity is an important factor in making PRI pricing decisions in the London PRI market. In addition to this, Palmer (2009) argued that limited capacity in the private PRI market is the single largest contributing factor to the pricing volatility.

Figure 5.5: Iraq scenario risk pricing

<table>
<thead>
<tr>
<th>Rate (%)</th>
<th>PRI Market</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Up to 0.5%</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>0</td>
<td>15</td>
</tr>
<tr>
<td>North America</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>EU</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Asia</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Africa</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>0</td>
<td>35</td>
</tr>
<tr>
<td></td>
<td>0.51-1%</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>North America</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>EU</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Asia</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Africa</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>1</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td>1.01-1.5%</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>3</td>
<td>7</td>
</tr>
<tr>
<td>North America</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>EU</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Asia</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Africa</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>6</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>1.51-2%</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>7</td>
<td>13</td>
</tr>
<tr>
<td>North America</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>EU</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Asia</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Africa</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>2.01-2.5%</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>4</td>
<td>13</td>
</tr>
<tr>
<td>North America</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>EU</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Asia</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Africa</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>13</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td>2.51-3%</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>5</td>
<td>15</td>
</tr>
<tr>
<td>North America</td>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td>EU</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Asia</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Africa</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>Over 3%</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>0</td>
<td>15</td>
</tr>
<tr>
<td>North America</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>EU</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Africa</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>0</td>
<td>10</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Rate (%)</th>
<th>PRI Market</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2.5-3%</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>5</td>
<td>15</td>
</tr>
<tr>
<td>North America</td>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td>EU</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Asia</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Africa</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>13</td>
<td>35</td>
</tr>
<tr>
<td></td>
<td>Over 3%</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>0</td>
<td>15</td>
</tr>
<tr>
<td>North America</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>EU</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Asia</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Africa</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>0</td>
<td>75</td>
</tr>
</tbody>
</table>

155
Table 5.7: Risk selection and pricing comparison between the UK PRI market and other jurisdictions including control group for Iraq risk scenario.

<table>
<thead>
<tr>
<th>JURISDICTION</th>
<th>Risk Acceptance (LINEir) Median</th>
<th>Median differences p-values</th>
<th>Risk Pricing (RATEir) Median</th>
<th>Median differences p-values</th>
</tr>
</thead>
<tbody>
<tr>
<td>North American market</td>
<td>2.00</td>
<td>0.047*</td>
<td>6.00</td>
<td>0.144</td>
</tr>
<tr>
<td>EU market</td>
<td>3.00</td>
<td>0.077†</td>
<td>6.00</td>
<td>0.533</td>
</tr>
<tr>
<td>Asian market</td>
<td>2.00</td>
<td>0.245</td>
<td>7.00</td>
<td>0.916</td>
</tr>
<tr>
<td>African market</td>
<td>3.00</td>
<td>0.011*</td>
<td>5.00</td>
<td>0.009**</td>
</tr>
<tr>
<td>Control group</td>
<td>2.00</td>
<td>0.005**</td>
<td>6.00</td>
<td>0.055†</td>
</tr>
</tbody>
</table>

Notes:
1. The non-parametric Mann-Whitney-U test was used to perform statistical differences for LINEir and RATEir categorical variables.
2. LINEir takes a value of 1 if participant declined a risk, 2 if accepted up to US$5 million, 3 if accepted at US$5-US$10 million level, 4 if accepted at US$10-US$20 million level, 5 if accepted at US$20-US$40 million level and 6 if accepted at more than US$40 million level.
3. RATEir takes a value of 1 if participant priced a risk up to 0.5%, 2 if priced a risk in a range of 0.51-1%, 3 if priced a risk in a range of 1.01-1.5%, 4 if priced a risk in a range of 1.51-2%, 5 if priced a risk in a range of 2.01-2.5%, 6 if priced a risk in a range of 2.5-3% range and 7 if priced a risk over 3%.
4. Marginally significant at p<0.10, * p<0.05, ** p<0.01, *** p<0.001

5.4.2.2 Iraq Risk Factor Analysis Results

Table 5.8 presents the results on the Iraq risk scenario on the ten items of consideration for both PRI experts and control group participants. The majority of the surveyed PRI experts agreed that the tenor requested (FOURir – 83.6%) and client’s PRI claims history was very important in making an underwriting decision (EIGHTir – 71.3%). Approximately half of the PRI experts surveyed thought the fact that Iraq’s total reserves including gold (as % of GDP), 54% at the time of study, to be important (TWOir – 54.1%). The following items, such as the US withdrawal of its’ troops from Iraq by the end of 2011 (THREEir – 47.3%), the next Iraqi election (SIXir - 42.4%), the fact that Iraq was unrated by Standards & Poors (S&P) and Moody’s rating agencies (NINEir – 45.9%) and that the client was an American company (TENir – 47.38%), were of a lesser importance to the PRI expert group as the whole. The fact that potential insured was in a good financial position (ONEir – 39.2%), the facility to retrocede part of the risk (FIVEir – 37.2%) as well as Iraq GDP growth rate (SEVENir – 35.6%) were considered to be only moderately important by the PRI expert group. One more apparent difference between PRI expert group and control group was that the majority
Table 5.8: Findings on the ten items of consideration for Iraq risk scenario for both the PRI expert and control groups (PRI.E stands for PRI Expert group and N.E – stands for control group).

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
<th>PRI.E</th>
<th>N.E</th>
<th>PRI.E</th>
<th>N.E</th>
<th>PRI.E</th>
<th>N.E</th>
<th>PRI.E</th>
<th>N.E</th>
<th>PRI.E</th>
<th>N.E</th>
<th>PRI.E</th>
<th>N.E</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ONEir:</strong> The potential insured is in a strong financial position</td>
<td>6 8,1%</td>
<td>11 14,9%</td>
<td>28 37,8%</td>
<td>20 27,0%</td>
<td>9 12,2%</td>
<td>1 3,4%</td>
<td>5 17,2%</td>
<td>6 20,7%</td>
<td>9 31,0%</td>
<td>8 27,6%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>TWOir:</strong> Iraq’s total reserves including gold (% of GDP) is 54%</td>
<td>3 4,2%</td>
<td>13 18,1%</td>
<td>17 23,6%</td>
<td>23 31,9%</td>
<td>16 22,2%</td>
<td>2 7,4%</td>
<td>4 14,8%</td>
<td>9 33,3%</td>
<td>9 33,3%</td>
<td>3 11,1%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>THREEir:</strong> The US will withdraw all of its forces (approximately 50,000 troops) from Iraq by the end of 2011.</td>
<td>3 4,1%</td>
<td>14 18,9%</td>
<td>22 29,7%</td>
<td>25 33,8%</td>
<td>10 13,5%</td>
<td>2 6,9%</td>
<td>2 6,9%</td>
<td>14 48,3%</td>
<td>6 20,7%</td>
<td>5 17,2%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>FOURir:</strong> The tenor for the policy requested is 90 days.</td>
<td>2 2,7%</td>
<td>4 5,5%</td>
<td>6 8,2%</td>
<td>31 42,5%</td>
<td>30 41,1%</td>
<td>1 3,4%</td>
<td>0 0,0%</td>
<td>2 6,9%</td>
<td>11 37,9%</td>
<td>15 51,7%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>FIVEir:</strong> Your facility to retrocede part of the risk</td>
<td>6 8,6%</td>
<td>13 18,6%</td>
<td>25 35,7%</td>
<td>17 24,3%</td>
<td>9 12,9%</td>
<td>0 0,0%</td>
<td>2 6,9%</td>
<td>9 31,0%</td>
<td>10 34,5%</td>
<td>8 27,6%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>SIXir:</strong> The next Iraqi national election is at least three years away.</td>
<td>4 5,5%</td>
<td>15 20,5%</td>
<td>23 31,5%</td>
<td>25 34,2%</td>
<td>6 8,2%</td>
<td>2 6,9%</td>
<td>3 10,3%</td>
<td>13 44,8%</td>
<td>8 27,6%</td>
<td>3 10,3%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>SEVENir:</strong> Iraq GDP growth rate is 0.8% (2010 est.)</td>
<td>4 5,5%</td>
<td>14 19,2%</td>
<td>29 39,7%</td>
<td>23 31,5%</td>
<td>3 4,1%</td>
<td>2 7,1%</td>
<td>5 17,9%</td>
<td>16 57,1%</td>
<td>4 14,3%</td>
<td>1 3,6%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>EIGHTir:</strong> Whether the potential insured has a claims history using PRI and/or Credit insurance</td>
<td>1 1,4%</td>
<td>5 6,8%</td>
<td>15 20,5%</td>
<td>24 32,9%</td>
<td>28 38,4%</td>
<td>1 3,4%</td>
<td>1 3,4%</td>
<td>2 6,9%</td>
<td>11 37,9%</td>
<td>14 48,3%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>NINEir:</strong> Iraq is unrated by S&amp;P or Moody’s</td>
<td>4 5,6%</td>
<td>20 27,8%</td>
<td>15 20,8%</td>
<td>21 29,2%</td>
<td>12 16,7%</td>
<td>6 20,7%</td>
<td>6 20,7%</td>
<td>6 20,7%</td>
<td>4 13,8%</td>
<td>7 24,1%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>TENir:</strong> The fact that the potential insured is an American company</td>
<td>6 8,1%</td>
<td>8 10,8%</td>
<td>25 33,8%</td>
<td>25 33,8%</td>
<td>10 13,5%</td>
<td>1 3,4%</td>
<td>9 31,0%</td>
<td>3 10,3%</td>
<td>11 37,9%</td>
<td>5 17,2%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
of control group participants expressed their opinion that ability to reinsure a part of the risk was important consideration in making the underwriting decision (FIVEir – 62.2%).

In addition to the ten items of consideration, other factors mentioned by the surveyed PRI experts in the comment section included deductible and the insured’s experience. Consider the following:

*Retention and experience will be the main drivers of the decision, which are not present among the choices. Grain is a fundamental commodity, hence strategic. Important to see whether this is going to be a one off or if Cargill has other interests in Iraq – The UK PRI market participant*

Table 5.9 provides the descriptive statistics for four category groupings for the UK PRI expert group. These are political factors (POLir), economic factors (ECOir), client-specific factors (INSir) and technical factors (TECHir). THREEir and SIXir were grouped into political factors category. TWOir, SEVENir and NINEir were selected into economic factors group. ONEir, EIGHTir and TENir were included into client factor group and FOURir and FIVEir into technical factor category. The UK PRI expert group again indicated that client specific factors were the most important in making an underwriting decision. In addition the surveyed experts found that technical factors such as tenor and reinsurance agreement were relatively more important than political and economic factors. This could be due to the fact that this is a short-term policy and policy technical factors are more important than political and economic projections.

**Table 5.9** Descriptive analysis. This table gives the descriptive statistics for the four factor categories for Iraq risk scenario for the UK PRI market (N= 26).

<table>
<thead>
<tr>
<th>Category</th>
<th>Mean</th>
<th>Standard Deviation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Political factors category (POLir)</td>
<td>3.135</td>
<td>0.889</td>
<td>1.00</td>
<td>4.50</td>
</tr>
<tr>
<td>Economic factors category (ECOir)</td>
<td>3.064</td>
<td>0.748</td>
<td>1.67</td>
<td>5.00</td>
</tr>
<tr>
<td>Insured factor category (INSir)</td>
<td>3.462</td>
<td>0.844</td>
<td>1.00</td>
<td>5.00</td>
</tr>
<tr>
<td>Technical factors category (TECHir)</td>
<td>3.442</td>
<td>1.013</td>
<td>1.00</td>
<td>5.00</td>
</tr>
</tbody>
</table>

5.4.3 Scenario Three: Kazakhstan Non-payment Risk Analysis

This scenario was designed in order to gain a better understanding of which factors were important considerations in making an underwriting decision in relation to a
government non-payment risk. This product is usually bought by banks which seek to protect their loan books in less developed countries and/or for regulatory reasons. Under the Basel II banking regulation, banks can get regulatory capital relief if their assets are securitised. In this scenario, a study participant was informed that an investment bank was considering issuing a loan worth of US$100 million to the Ministry of Finance of the Republic of Kazakhstan. It was stated that the bank has made an inquiry for US$30 million coverage with 7-year tenor against the government non-payment risk. The study participant was asked to make an underwriting decision in regards to the risk.

The next section presents findings on the Kazakhstan risk scenario.

5.4.3.1 Kazakhstan Risk Acceptance and Pricing

The average risk acceptance level for the PRI expert group was between US$5 million and US$10 million and was higher for the control group at a level of US$10 million to US$20 million. Out of 75 surveyed PRI experts, 13 (17.3%) declined the risk, of which the majority were from the UK PRI market, 4 participants from the North America market, 1 participant each from the Asia market and Africa markets (see Figure 5.6). The Mann-Whitney-U test results showed that the UK PRI market had significantly lower risk acceptance levels as compared with the EU PRI market at 0.05 level (p=0.015) and the control group at 0.05 (p=0.48), which is in line with hypotheses 4a and 4b, respectively (see Table 5.10). There was no statistical difference found between the UK market’s risk acceptance levels and North American, Asian or African PRI markets for which hypothesis 4a is rejected. According to the PRI expert group’s comments, the following were risk attributes that had a negative effect on participants’ risk acceptance levels: the length of tenor, negative country trend and claims history involving Kazakhstan. Consider the following comments:

I would decline this risk, its too long tail and the country / political risk is showing a negative trend given current market conditions – The UK PRI market participant

Kazakhstan has rescheduled the debt of BTA which was problematic which is highly negative. – The UK PRI market participant
An average rate of between 2.01% and 2.5%, was proposed by the PRI expert group for a contract of risk acceptance. This was the same for the control group. 14 participants (18.6 %) from the PRI expert group said that a rate for the Kazakhstan risk should be over 3 % and no one from this group thought that the rate should be lower than 0.5% (see Figure 5.7). According to the Mann-Whitney-U test results, the UK’s PRI market pricing was only marginally lower than Asian PRI market pricing and there was no difference between the UK PRI market and the other markets surveyed or the control group. Consequently, hypotheses 5a and 5b can be rejected, indicating that the UK PRI pricing patterns for the Kazakhstan risk were not statistically different from the four surveyed PRI markets or the control group (see Table 5.10).
Figure 5.7: Kazakhstan scenario risk pricing

Table 5.10: Risk selection and pricing comparison between the UK PRI market and other jurisdictions including control group for Kazakhstan risk scenario.

<table>
<thead>
<tr>
<th>JURISDICTION</th>
<th>Risk Acceptance (LINEk)</th>
<th>Risk Pricing (RATEk)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Median</td>
<td>Median differences p-values</td>
</tr>
<tr>
<td>North American market</td>
<td>3.00</td>
<td>0.832</td>
</tr>
<tr>
<td>EU market</td>
<td>5.00</td>
<td>0.015*</td>
</tr>
<tr>
<td>Asian market</td>
<td>4.00</td>
<td>0.142</td>
</tr>
<tr>
<td>African market</td>
<td>4.00</td>
<td>0.295</td>
</tr>
<tr>
<td>Control group</td>
<td>4.00</td>
<td>0.048*</td>
</tr>
</tbody>
</table>

Notes:
1. The non-parametric Mann-Whitney-U test was used to perform statistical differences for LINEk and RATEk categorical variables.
2. LINEk takes a value of 1 if participant declined a risk, 2 if accepted up to US$5 million, 3 if accepted at US$5-US$10 million level, 4 if accepted at US$10-US$20 million at level, 5 if accepted at US$20-US$40 million level and 6 if accepted at more than US$40 million level.
3. RATEk takes a value of 1 if participant priced a risk up to 0.5%, 2 if priced a risk in a range of 0.51-1%, 3 if priced a risk in a range of 1.01-1.5%, 4 if priced a risk in a range of 1.51-2%, 5 if priced a risk in a range of 2.01-2.5%, 6 if priced a risk in a range of 2.5-3% range and 7 if priced a risk over 3%.
4. Marginally significant at p<0.10, * p<0.05, ** p<0.01, *** p<0.001
5.4.3.2 Kazakhstan Risk Factor Analysis Results

Table 5.11 illustrates the study participants’ responses in regard to ten items of consideration relating to the Kazakhstan risk. The insured’s reason for applying for government non-payment coverage (SIXk – 83.7%), whether the bank’s proposed premium is adequate for a contract of risk acceptance (EIGHTk - 83.7%), Kazakh sovereign credit rating (NINEk – 82.6), whether a participant has had previous dealings with the bank (SEVENk – 81.1%) and Kazakh government debt (TWOk – 75.7%) were the most important factors out of ten items of consideration in considering the risk as identified by the PRI expert group. The President’s re-election (ONEk – 62.2%), the fact that potential insured was a well-known bank (TENk – 56.1%), market prices for CDS (THREEk – 55.6%), Kazakhstan’s GDP (FIVEk – 50%) and facility to retrocede part of the risk (FOURk – 41.9%) were not as important.

According to the PRI experts’ comments, factors that would be important in considering government’s non-payment risk, which were not specified in the ten items of consideration, were: deductible, loan amortization, whether it was a direct Ministry of Finance (MOF) obligation and the project’s importance to the host government. The Insured’s risk retention reduces the moral hazard problem and, according to the study participants, demonstrates the insured’s trust in borrower’s capability to meet its obligations. As one PRI expert explained:

*Retention will be a key. It will show confidence in the risk* – The UK PRI market participant

The PRI market participants also differentiated between loans that amortize over a period and those that are repaid in full upon maturity. A loan that amortizes over time is a relatively lower risk; that is, the expected loss diminishes as the loan approaches maturity. Consider the following:

*A key factor in underwriting this risk is whether the loan amortizes over seven years or is repaid in full at maturity.* – The UK PRI market participant

A number of the study participants expressed that the risk would be more acceptable if it had been a direct MOF obligation. This is best illustrated by the PRI expert’s words:
Table 5.11: Findings on the ten items of consideration for Kazakhstan risk scenario for both the PRI expert and control groups (PRI.E stands for PRI Expert group and N.E – stands for control group).

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
<th>PRI.E</th>
<th>N.E</th>
<th>PRI.E</th>
<th>N.E</th>
<th>PRI.E</th>
<th>N.E</th>
<th>PRI.E</th>
<th>N.E</th>
<th>PRI.E</th>
<th>N.E</th>
</tr>
</thead>
<tbody>
<tr>
<td>ONEk</td>
<td>Kazakhstan President Nursultan Nazarbayev was re-elected in 2010 for another seven-year term</td>
<td>1 1,4%</td>
<td>1 3,4%</td>
<td>8 10,8%</td>
<td>2 6,9%</td>
<td>19 25,7%</td>
<td>8 27,6%</td>
<td>31 41,9%</td>
<td>10 34,5%</td>
<td>15 20,3%</td>
<td>8 27,6%</td>
</tr>
<tr>
<td>TWOk</td>
<td>Kazakh government debt, total (% of GDP): 5.2% (2007), 6.3% (2008) and 9.5% (2009)</td>
<td>0 ,0%</td>
<td>1 3,6%</td>
<td>2 2,7%</td>
<td>0 ,0%</td>
<td>16 21,6%</td>
<td>8 28,6%</td>
<td>29 39,2%</td>
<td>9 32,1%</td>
<td>27 36,5%</td>
<td>10 35,7%</td>
</tr>
<tr>
<td>THREEk</td>
<td>Current market prices for Credit Default Swap (CDS)</td>
<td>2 2,8%</td>
<td>0 ,0%</td>
<td>10 13,9%</td>
<td>3 10,3%</td>
<td>20 27,8%</td>
<td>10 34,5%</td>
<td>28 38,9%</td>
<td>13 44,8%</td>
<td>12 16,7%</td>
<td>3 10,3%</td>
</tr>
<tr>
<td>FOURk</td>
<td>Your facility to retrocede part of the risk</td>
<td>7 9,5%</td>
<td>0 ,0%</td>
<td>14 18,9%</td>
<td>2 6,9%</td>
<td>22 29,7%</td>
<td>7 24,1%</td>
<td>24 32,4%</td>
<td>12 41,4%</td>
<td>8 27,6%</td>
<td>8 27,6%</td>
</tr>
<tr>
<td>FIVEk</td>
<td>Kazakhstan’s GDP is US$ 142 billion</td>
<td>0 ,0%</td>
<td>2 6,9%</td>
<td>12 16,7%</td>
<td>5 17,2%</td>
<td>24 33,3%</td>
<td>10 34,5%</td>
<td>28 38,9%</td>
<td>9 31,0%</td>
<td>8 11,1%</td>
<td>8 11,1%</td>
</tr>
<tr>
<td>SIXk</td>
<td>The reason why Barclays wants to buy coverage</td>
<td>1 1,4%</td>
<td>0 ,0%</td>
<td>4 5,4%</td>
<td>3 10,7%</td>
<td>7 25,0%</td>
<td>6 21,4%</td>
<td>11 37,9%</td>
<td>2 6,9%</td>
<td>2 6,9%</td>
<td>7 9,5%</td>
</tr>
<tr>
<td>SEVENk</td>
<td>Whether you have had previous dealings with this bank</td>
<td>2 2,7%</td>
<td>1 3,4%</td>
<td>0 ,0%</td>
<td>2 6,9%</td>
<td>12 16,2%</td>
<td>6 20,7%</td>
<td>33 44,6%</td>
<td>12 42,9%</td>
<td>27 36,5%</td>
<td>27 36,5%</td>
</tr>
<tr>
<td>EIGHTk</td>
<td>Whether you think the bank’s proposed premium is adequate for you to accept the risk</td>
<td>0 ,0%</td>
<td>1 3,4%</td>
<td>1 1,4%</td>
<td>3 10,3%</td>
<td>11 14,9%</td>
<td>5 17,2%</td>
<td>26 35,1%</td>
<td>9 31,0%</td>
<td>36 48,6%</td>
<td>14 41,4%</td>
</tr>
<tr>
<td>NINEk</td>
<td>The host country’s credit rating</td>
<td>0 ,0%</td>
<td>2 6,9%</td>
<td>1 1,3%</td>
<td>4 13,8%</td>
<td>12 16,0%</td>
<td>11 37,9%</td>
<td>34 45,3%</td>
<td>7 24,1%</td>
<td>28 37,3%</td>
<td>5 17,2%</td>
</tr>
<tr>
<td>TENk</td>
<td>The fact that the potential insured is a well-known bank</td>
<td>2 2,7%</td>
<td>0 ,0%</td>
<td>5 6,8%</td>
<td>4 13,8%</td>
<td>25 34,2%</td>
<td>9 31,0%</td>
<td>26 35,6%</td>
<td>12 41,4%</td>
<td>15 20,5%</td>
<td>2 6,9%</td>
</tr>
</tbody>
</table>
Would only consider if it was an MOF obligation – The UK PRI market participant

An importance of the project to the host country, i.e. priority in the government’s overall business, was an important consideration to the PRI market experts. The projects that are essential to the host government were perceived as a lower risk. Consider the following:

I wouldn't cover this unless I understood how important the particular project is. I would also want to know who the contractor is. If I was satisfied with the answer and the use of proceeds was clear in the loan agreement, then I would offer $25m – The UK PRI market participant.

Table 5.12 reports the descriptive statistics for the political (POLk), economic (ECOk), client (INSk) and technical (TECHk) factor categories. ONEk item was included in the political factor category. TWOk, THREEk, FIVEk and NINEk were grouped in the economic factor category. SIXk, SEVENk and TENk were selected for the client factor category and FOURk and EIGHTk for the technical factor category. In line with the previous risk scenarios, the insured factor category had the highest mean value, indicating that the surveyed UK PRI market experts considered client-specific factors to be the most important in making an underwriting decision. In addition, host country economic factors were relatively more important than political factors. Government non-payment risk is ultimately sovereign credit risk, therefore PRI underwriters spend a considerable amount of time analysing the host country financial economic situation.

Table 5.12: Descriptive analysis and Mann-Whitney-U test results. This table gives the descriptive statistics for the four factor categories for Kazakhstan risk scenario for the UK PRI market (N= 26).

<table>
<thead>
<tr>
<th>Factor Category</th>
<th>Mean</th>
<th>Standard Deviation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Political factors category (POLk)</td>
<td>3.692</td>
<td>0.928</td>
<td>2.00</td>
<td>5.00</td>
</tr>
<tr>
<td>Economic factors category (ECOk)</td>
<td>3.872</td>
<td>0.614</td>
<td>2.50</td>
<td>5.00</td>
</tr>
<tr>
<td>Insured factor category (INSk)</td>
<td>4.077</td>
<td>0.675</td>
<td>2.33</td>
<td>5.00</td>
</tr>
<tr>
<td>Technical factors category (TECHk)</td>
<td>3.635</td>
<td>0.794</td>
<td>2.50</td>
<td>5.00</td>
</tr>
</tbody>
</table>
5.4.4 Scenario Four: Saudi Arabia Power Project Risk Analysis

This scenario was designed in order to explore PRI market experts’ attitudes towards risks that are slightly unusual. Generally, PRI participants receive requests from investors from developed countries to insure their exposure in emerging and developing countries. It is uncommon for an investor from less developed countries to seek PRI coverage. In this hypothetical risk scenario, a private Russian company was planning to start *Farasan Solar Park*, a 400 KW solar power plant, located on Farasan Island in southwest Saudi Arabia. Under the investor – Saudi Arabian agreement, the company would own the project for up to 10 years, after which the assets would be reassigned to the Saudi Electricity Company (SEC). The company would own 80% of *Farasan Solar Park*, though the lifespan of the project with the remaining 20% would be held by SEC. The following were the perils the client wanted to insure: confiscation, expropriation, and nationalization, currency inconvertibility, non-transfer, contract frustration, license cancellation and political violence. The tenor requested was 10 years and the coverage was US$170 million. The PRI expert group and the control group were asked to make an underwriting decision regarding the risk.

The following section outlines findings on the statistical analysis carried out on data gathered from PRI experts and non-experts on the Saudi Arabia risk scenario.

5.4.4.1 Saudi Arabia Risk Acceptance and Pricing

The average level of risk acceptance for the PRI expert group was between US$10 million and US$20 million range and in the US$20 million and US$40 million range for the control group. Out of 75 surveyed PRI experts, 18 participants (24.0%) declined the Saudi Arabia risk, of which 10 were from the UK market, 6 from the North America market and one each from the EU and Asia markets (see Figure 5.8). According to the Mann-Whitney-U test results, the UK PRI market participants surveyed were more risk-averse than the North American PRI experts at 0.05 level (p=0.019), the EU PRI market experts at 0.01 level.
(p=0.008) and Africa PRI market at 0.05 (p=0.022) (see Table 5.4.4.1). This finding is in line with hypothesis 4a. There was no statistical difference between the UK PRI market experts and Asian PRI experts’ risk acceptance levels. Consistent with the previous three risk scenarios, the control group found the Saudi Arabia risk to be more acceptable than the UK PRI expert group, at 0.001 level (p=0.000), which supports hypothesis 4b.

**Figure 5.8:** Saudi Arabia scenario risk acceptance levels

![Saudi Arabia scenario risk acceptance levels](image)

<table>
<thead>
<tr>
<th>PRI Market</th>
<th>Decline risk</th>
<th>Up to $5m</th>
<th>$5-$10m</th>
<th>$10-$20m</th>
<th>$20-$40m</th>
<th>More than $40m</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>10</td>
<td>1</td>
<td>3</td>
<td>6</td>
<td>4</td>
<td>2</td>
<td>26</td>
</tr>
<tr>
<td>North America</td>
<td>6</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>8</td>
<td>8</td>
<td>25</td>
</tr>
<tr>
<td>EU</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>Asia</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>0</td>
<td>4</td>
<td>9</td>
</tr>
<tr>
<td>Africa</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>2</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>18</td>
<td>3</td>
<td>8</td>
<td>9</td>
<td>16</td>
<td>21</td>
<td>75</td>
</tr>
</tbody>
</table>

From the PRI experts’ comments analysis, it seems there were two main reasons why a number of participants declined the risk. Firstly, a number of participants said that the ten-year tenor was too long for them to be willing to take on the risk. Consider the following:

*10-year period is too long – The UK PRI market participant*
Will not go beyond 7 years – The Asia PRI market participant

Would not insure due to the 10-year tenure – The North America PRI market participant

According to Arthur J. Gallagher (2011) report, out of 34 London private PRI market providers 8 PRI insurers can issue 10-year PRI policies. The longer a tenor, the longer it takes for PRI provider to earn its premium. In addition, the longer the tenor, the more difficult it becomes to project and forecast political events. This in turn progressively introduces more uncertainty into the pricing and portfolio management processes. The competition between private PRI market providers is significantly reduced once a tenor requested is longer than 7 years, as there are only a limited number of insurers which would be willing to take on such risks. The second reason for declining the risk, which was commented upon by the PRI experts surveyed, was the fact that the potential insured was a Russian company. This is best expressed in participants’ words:

Russian Insured = no go – The UK PRI market participant

Too much inherent political risk here. Russian insured, Saudi succession risk (two generations with on risk horizon likely) – The UK PRI market participant

This is a risk that I would like to write but would first have to check whether I am licensed to issue Policies to a Russian Insured???????? And there are not very many specialist Insurers that are – The UK PRI market participant

It appears that the PRI market participants perceive applications for PRI coverage from investors from less developed countries to be higher political risks and in turn, less acceptable. This could be due to a notion that potential insured from a high political risk country is automatically perceived to be a higher risk in itself.

The majority of the PRI experts surveyed expressed that an appropriate rate for a contract of risk acceptance was between 1.01% and 2% range. Half of the UK PRI expert group identified that they would charge a rate between 1.01% and 1.5%. The Mann-Whitney-U test results indicated that the UK PRI market pricing was only marginally different from the EU market and Asia market pricing at 0.10 level (p= 0.086 and p=0.066, respectively).
There was no statistical difference found between the UK PRI market and the North America market and Africa market, as well as the control group pricing (see Table 5.13). Consequently, hypotheses 5a and 5b are rejected at 0.05 level of significance, indicating that there were no differences in pricing patterns between the five PRI jurisdictions surveyed and the control group.

**Figure 5.9:** Saudi Arabia scenario risk pricing

<table>
<thead>
<tr>
<th>PRI Market</th>
<th>Up to 0.5%</th>
<th>0.51-1%</th>
<th>1.01-1.5%</th>
<th>1.51-2%</th>
<th>2.01-2.5%</th>
<th>2.51-3%</th>
<th>Over 3%</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>0</td>
<td>4</td>
<td>13</td>
<td>5</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>26</td>
</tr>
<tr>
<td>North America</td>
<td>0</td>
<td>4</td>
<td>9</td>
<td>9</td>
<td>0</td>
<td>2</td>
<td>1</td>
<td>25</td>
</tr>
<tr>
<td>EU</td>
<td>1</td>
<td>4</td>
<td>3</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td>Asia</td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>3</td>
<td>9</td>
</tr>
<tr>
<td>Africa</td>
<td>0</td>
<td>0</td>
<td>2</td>
<td>3</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>1</td>
<td>13</td>
<td>29</td>
<td>19</td>
<td>2</td>
<td>4</td>
<td>5</td>
<td>75</td>
</tr>
</tbody>
</table>
Table 5.13: Risk selection and pricing comparison between the UK PRI market and other jurisdictions including control group for Saudi Arabia risk scenario.

<table>
<thead>
<tr>
<th>JURISDICTION</th>
<th>Risk Acceptance (LINEs)</th>
<th>Risk Pricing (RATEs)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Median</td>
<td>Median differences p-values</td>
</tr>
<tr>
<td>North American market</td>
<td>5.00</td>
<td>0.019*</td>
</tr>
<tr>
<td>EU market</td>
<td>6.00</td>
<td>0.008**</td>
</tr>
<tr>
<td>Asian market</td>
<td>4.00</td>
<td>0.117</td>
</tr>
<tr>
<td>African market</td>
<td>5.00</td>
<td>0.022*</td>
</tr>
<tr>
<td>Control group</td>
<td>5.00</td>
<td>0.000***</td>
</tr>
</tbody>
</table>

Notes:
1. The non-parametric Mann-Whitney-U test was used to perform statistical differences for LINEs and RATEs categorical variables.
2. LINEs takes a value of 1 if participant declined a risk, 2 if accepted up to US$5 million, 3 if accepted at US$5-US$10 million level, 4 if accepted at US$10-US$20 million at level, 5 if accepted at US$20-US$40 million level and 6 if accepted at more than US$40 million level.
3. RATEs takes a value of 1 if participant priced a risk up to 0.5%, 2 if priced a risk in a range of 0.51-1%, 3 if priced a risk in a range of 1.01-1.5%, 4 if priced a risk in a range of 1.51-2%, 5 if priced a risk in a range of 2.01-2.5%, 6 if priced a risk in a range of 2.5-3% range and 7 if priced a risk over 3%.
4. *Marginally significant at p<0.10, * p<0.05, ** p<0.01, *** p<0.001

5.4.4.2 Saudi Arabia Factor Analysis Results

Table 5.14 reports results for both the PRI expert group and the control group on ten items of consideration for the Saudi Arabia hypothetical risk scenario. The fact that the risk was in the energy sector (SIXs – 92.0%) was the most important factor to the PRI expert group. The majority of the PRI experts surveyed also identified that Saudi Arabia’s membership in the ICSID (TWOs – 74%) and the desired size of coverage (SEVENs – 71.6%) were important considerations in making an underwriting decision. In descending order of importance, Saudi Arabia’s current account surplus (FOURs -67.1%), the expected trend in the global price of oil (NINEs – 62.7%), that the potential insured was a Russian company (FIVEs – 56.9%), the origin of Saudi Arabia’s legal system (THREEs – 53.5%) and the fact that Saudi Arabia is a monarchy (ONEs – 51.3%) were of a lesser relevance. Less than half of the PRI participants surveyed thought that Russia and Saudi Arabia’s competition for oil market share (TENs – 33.4%) and facility to retrocede part of the risk.
Table 5.14: Findings on the ten items of consideration for Saudi Arabia risk scenario for both the PRI expert and control groups (PRI.E stands for PRI Expert group and N.E – stands for control group).

<table>
<thead>
<tr>
<th>Items</th>
<th>Unimportant</th>
<th>Of little importance</th>
<th>Moderately important</th>
<th>Important</th>
<th>Very important</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>PRI.E</td>
<td>N</td>
<td>N %</td>
<td>N</td>
<td>N %</td>
</tr>
<tr>
<td>ONEs:</td>
<td>Saudi Arabia is a monarchy with a Council of Ministers and a Consultative Council, where formal political parties are not recognized and have no legal status.</td>
<td>2</td>
<td>2,7%</td>
<td>10</td>
<td>13,5%</td>
</tr>
<tr>
<td></td>
<td>N.E</td>
<td>0</td>
<td>0,0%</td>
<td>8</td>
<td>27,6%</td>
</tr>
<tr>
<td>TWOs:</td>
<td>Saudi Arabia is a member of the International Centre for Settlements of Investment Disputes (ICSID).</td>
<td>0</td>
<td>0,0%</td>
<td>4</td>
<td>5,5%</td>
</tr>
<tr>
<td></td>
<td>N.E</td>
<td>1</td>
<td>3,6%</td>
<td>3</td>
<td>10,7%</td>
</tr>
<tr>
<td>THREEs:</td>
<td>Saudi Arabia’s legal system originates from English common law.</td>
<td>1</td>
<td>1,4%</td>
<td>11</td>
<td>15,5%</td>
</tr>
<tr>
<td></td>
<td>N.E</td>
<td>1</td>
<td>3,4%</td>
<td>0</td>
<td>0,0%</td>
</tr>
<tr>
<td>FOURs:</td>
<td>Saudi Arabia’s current account surplus was US$22 billion in 2009.</td>
<td>0</td>
<td>0,0%</td>
<td>2</td>
<td>2,7%</td>
</tr>
<tr>
<td></td>
<td>N.E</td>
<td>2</td>
<td>7,1%</td>
<td>1</td>
<td>3,6%</td>
</tr>
<tr>
<td>FIVEs:</td>
<td>The potential insured’s home country is Russia.</td>
<td>2</td>
<td>2,8%</td>
<td>7</td>
<td>9,7%</td>
</tr>
<tr>
<td></td>
<td>N.E</td>
<td>1</td>
<td>3,6%</td>
<td>1</td>
<td>3,6%</td>
</tr>
<tr>
<td>SIXs:</td>
<td>The risk is in the energy sector.</td>
<td>0</td>
<td>0,0%</td>
<td>3</td>
<td>4,0%</td>
</tr>
<tr>
<td></td>
<td>N.E</td>
<td>0</td>
<td>0,0%</td>
<td>0</td>
<td>0,0%</td>
</tr>
<tr>
<td>SEVENs:</td>
<td>The desired size of coverage.</td>
<td>0</td>
<td>0,0%</td>
<td>6</td>
<td>8,1%</td>
</tr>
<tr>
<td></td>
<td>N.E</td>
<td>0</td>
<td>0,0%</td>
<td>0</td>
<td>0,0%</td>
</tr>
<tr>
<td>EIGHTs:</td>
<td>Your facility to retrocede part of the risk.</td>
<td>6</td>
<td>8,3%</td>
<td>13</td>
<td>18,1%</td>
</tr>
<tr>
<td></td>
<td>N.E</td>
<td>0</td>
<td>0,0%</td>
<td>3</td>
<td>10,7%</td>
</tr>
<tr>
<td>NINEs:</td>
<td>The expected trend in the global price of oil.</td>
<td>0</td>
<td>0,0%</td>
<td>5</td>
<td>6,7%</td>
</tr>
<tr>
<td></td>
<td>N.E</td>
<td>0</td>
<td>0,0%</td>
<td>2</td>
<td>7,1%</td>
</tr>
<tr>
<td>TENs:</td>
<td>Russia and Saudi Arabia compete for oil market share.</td>
<td>4</td>
<td>5,6%</td>
<td>13</td>
<td>18,1%</td>
</tr>
<tr>
<td></td>
<td>N.E</td>
<td>1</td>
<td>3,6%</td>
<td>5</td>
<td>17,9%</td>
</tr>
</tbody>
</table>
(EIGHTs – 45.8%) were important factors. In comparison, the control group considered the SEVENs (89.2%), SIXs (77.7%), FOURs (75.0%) and NINEs (75.0%) items as the important considerations in making an underwriting decision. In line with the previous four risk scenarios, the client’s experience with similar projects in less developed or emerging countries, as well as project’s importance to the host country, were qualities desired by the PRI experts surveyed. In addition, some of the surveyed PRI experts said that they would require an arbitration clause to be included in the policy. Consider the following:

*Would look for arbitration clause in the agreement, preferably outside Saudi Arabia* – The Asia PRI market participant

The purpose of an arbitration clause is to provide quicker commercial dispute resolution through arbitration than through the national judicial system. This allows the possibility of reaching settlement faster and in turn to receive any entitled recovery payments.

Table 5.15 provides descriptive statistics for political factor (POLs), economic factor (ECOs), client-specific factor (INSs) and technical factor (TECHs) categories for the UK PRI expert group. ONEs, TWOs, THREEs and TENs were included in the political factor category. FOURs and NINEs were grouped into economic factor category. FIVEs and SIXs were combined into client-specific factor category and SEVENs and EIGHTs into technical factor category. According to the descriptive statistics analysis results, the client-specific factors were perceived to be the most important by the PRI expert group in making an underwriting decision. This finding is consistent throughout all four hypothetical risk scenarios. Therefore, it could be argued that aspects relating to potential insured are the ones most likely to impact on perceptions of PRI underwriters as to what risks are acceptable or not for a portfolio of political risks.

**Table 5.15:** Descriptive analysis and Mann-Whitney-U test results. This table gives the descriptive statistics for the four factor categories for Saudi Arabia risk scenario for the UK PRI market (N= 26).

<table>
<thead>
<tr>
<th>Category</th>
<th>Mean</th>
<th>Standard Deviation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Political factors category (POLs)</td>
<td>3.442</td>
<td>0.736</td>
<td>2.25</td>
<td>5.00</td>
</tr>
<tr>
<td>Economic factors category (ECOs)</td>
<td>3.808</td>
<td>0.634</td>
<td>2.50</td>
<td>5.00</td>
</tr>
<tr>
<td>Insured factor category (INSs)</td>
<td>4.039</td>
<td>0.720</td>
<td>2.50</td>
<td>5.00</td>
</tr>
<tr>
<td>Technical factors category (TECHs)</td>
<td>3.173</td>
<td>0.999</td>
<td>1.50</td>
<td>5.00</td>
</tr>
</tbody>
</table>
5.5 Conclusion

This chapter outlined the results of statistical analysis executed on quantitative data gathered from PRI experts and non-experts using the research instrument designed for use in this study. The profiles of the study participant groups were outlined and hypotheses were developed based on the research questions that emerged from the literature review in Chapter 2. Table 5.16 summarises the findings for the hypotheses which have been tested to provide a context for the discussion of the results.

The dominant message emerging from the quantitative analysis of risk selection is that the UK PRI market participants had significantly lower risk acceptance levels compared to the other PRI jurisdictions or the control group. This is evident in the results of all four hypothetical risk scenarios. The UK PRI market in particular appeared to differ from the North America and the EU PRI markets in terms of risk aversion. This could be due to a number of reasons; such as reinsurance arrangements, internal risk governance mechanisms, market claims experience and/or cultural/legal differences. However, this could also be a result of how the risks were presented. The grounded theory results in Chapter 4 show that the UK PRI market participants prefer dealing face-to-face and this missing aspect could have had an effect on the risk selection process. Contrary to the hypotheses, all participants, both PRI experts and non-experts, had similar pricing patterns. This may have been driven by the use of same benchmarks such as CDS prices, which in turn resulted in similar pricing patterns. However, further analysis is required before any such conclusion can be reached.
### Table 5.16: Summary of results from statistical analysis of hypothesis

#### Panel A: The comparison between the UK PRI market and the four other surveyed PRI markets.

<table>
<thead>
<tr>
<th>Hypotheses</th>
<th>Indonesia risk</th>
<th>Iraq risk</th>
<th>Kazakhstan risk</th>
<th>Saudi Arabia risk</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Hypothesis 5a</strong>: When considering risks for a portfolio of political risks, the UK PRI experts will have lower levels of risk acceptance in comparison to PRI experts from other jurisdiction.</td>
<td>Supported</td>
<td>Supported</td>
<td>Rejected</td>
<td>Supported</td>
</tr>
<tr>
<td>North America PRI market</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EU PRI market</td>
<td>Supported</td>
<td>Rejected</td>
<td>Supported</td>
<td>Supported</td>
</tr>
<tr>
<td>Asia PRI market</td>
<td>Supported</td>
<td>Rejected</td>
<td>Rejected</td>
<td>Rejected</td>
</tr>
<tr>
<td>Africa PRI market</td>
<td>Rejected</td>
<td>Supported</td>
<td>Rejected</td>
<td>Supported</td>
</tr>
<tr>
<td><strong>Hypothesis 6a</strong>: The UK PRI experts will price political risk higher in comparison to PRI experts from other jurisdictions.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>North America PRI market</td>
<td>Rejected</td>
<td>Rejected</td>
<td>Rejected</td>
<td>Rejected</td>
</tr>
<tr>
<td>EU PRI market</td>
<td>Rejected</td>
<td>Rejected</td>
<td>Rejected</td>
<td>Rejected</td>
</tr>
<tr>
<td>Asia PRI market</td>
<td>Rejected</td>
<td>Rejected</td>
<td>Rejected</td>
<td>Rejected</td>
</tr>
<tr>
<td>Africa PRI market</td>
<td>Rejected</td>
<td>Supported</td>
<td>Rejected</td>
<td>Rejected</td>
</tr>
</tbody>
</table>

#### Panel B: The comparison between the UK PRI market and the control group.

<table>
<thead>
<tr>
<th>Hypotheses</th>
<th>Indonesia risk</th>
<th>Iraq risk</th>
<th>Kazakhstan risk</th>
<th>Saudi Arabia risk</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Hypothesis 5b</strong>: When considering risks for a portfolio of political risks, the UK PRI experts will have lower levels of risk acceptance in comparison to the control group.</td>
<td>Supported</td>
<td>Supported</td>
<td>Supported</td>
<td>Supported</td>
</tr>
<tr>
<td><strong>Hypothesis 6b</strong>: The UK PRI experts will price political risk higher in comparison to the control group.</td>
<td>Supported</td>
<td>Rejected</td>
<td>Rejected</td>
<td>Rejected</td>
</tr>
</tbody>
</table>
CHAPTER 6: Discussion of Findings

6.1 Introduction

This study breaks new ground by conceptualizing and examining different methods and strategies of political risk underwriting employed in the private UK insurance market which do not rely on statistical tools, as seen in more traditional insurance types. It is the first study to do this. The general findings of the present research show that the political risk underwriting process, and more particularly pricing, is a combination of art and science, which is in line with the existing PRI literature (see e.g., Palmer, 2009; Coppola, 2009; Sundberg, et al, 2009; and Ascarì, 2010). That is to say, there is a relatively large degree of human judgement involved in the process in the UK PRI market. This is largely to do with the fact that on a number of occasions PRI underwriters have to make an underwriting decision on political risks for which there is no historical data or experience. Not to mention that political risk deviates from the basic principles of insurability (see e.g., Ascarì 2010; Gordon 2008), which itself requires alternative risk assessment methods. In turn, PRI underwriters are forced, to a degree, to rely on their tacit skills, hunches and heuristics in the decision-making process. The tacit knowledge that comes from years of underwriting experience is perceived as one of the most strategically important resources in the PRI market community.

This chapter revisits the literature reviewed in the earlier chapters and considers it in the light of the findings presented in Chapter 4 and Chapter 5. The next two parts of this chapter synthesize and discuss the political risk selections and pricing frameworks which are the original contributions of this study. The fourth part reflects on the methodological approach taken to address the research questions. The final part concludes the chapter.
6.2 Political Risk Selection Framework in the UK Insurance Market

A mixed methods approach was adopted in this study in order to develop a framework for political risk selection in the context of the UK PRI market. A qualitative grounded theory analysis was carried out using data from 14 in-depth interviews and PRI market documentation (industry reports and PRI contracts). Given the lack of integrated theory in the risk and insurance literature regarding PRI and political risk underwriting, an inductive approach that allows theory to emerge from empirical data was deemed the most appropriate. Grounded theory analysis results informed the development of a scenario-based survey, which was purposely designed to complement the frameworks of political risk selection and pricing, which were developed in the first part of this study. There were 104 research instruments generated in the second phase of this research. The final version of political risk selection framework is presented in Figure 6.1.

This framework cannot be mapped on the existing PRI literature, as this is the first study to investigate the process of risk selection in the UK PRI market. According to the grounded theory analysis results, perceptions as to what risks are acceptable for a portfolio of political risks are influenced by both the explicit and implicit aspects of these risks. The explicit aspects refer to those characteristics that can be articulated, shared, codified and stored in some form of media, such as the host country political and economic factors, the client’s financial strength and other policy features (e.g., tenor, coverage and deductible). These explicit risk properties have an immediate impact on risk selection process and are usually used as the reference points in an underwriting policy. They can be considered as the primary political risk selection criteria, but they are not the only factors that are taken into consideration during the decision-making process.

The implicit risk properties also play an important role in the risk selection process. These properties refer to intangible qualities that are observable subconsciously at a risk assessment stage (e.g., reputation, trust and intuition). These properties trigger personal beliefs and biases that cannot be readily transmitted to others and are difficult to articulate or quantify. These implicit factors can in some instances override the strength of explicit risk selection factors. If one is to understand a risk selection process in the UK PRI market, both the explicit and implicit properties of a risk as well as their
interplay, must be considered. In other words, both selection criteria have to be met in order for a given political risk to be acceptable for a portfolio of risks. For example, if the risk satisfies technical underwriting requirements (i.e., explicit selection criteria) but an underwriter has no trust in a third party (e.g., a PR broker), then he or she may opt to reject otherwise acceptable risks. According to the grounded theory analysis results, the implicit risk selection criteria can be dominant if a risk is relatively more complex in comparison to more traditional political risks. Finally, explicit and implicit risk

Figure 6.1: Political risk selection framework in the UK private PRI market
selection factors complement each other whilst addressing two different aspects of the risk selection process. Explicit risk properties are analysed by PR underwriters in order to arrive at a relative level of political risk or at a subjective probability of a loss event taking place, whereas, implicit risk properties are utilised in order to manage adverse selection and moral hazard problems which arise from the uncertainty surrounding political risks. Arguably, this two-dimensional political risk selection model helps PR underwriters to convert uninsurable risks into insurable risks, even though in most instances they violate insurability principles such as randomness, accessibility and mutuality of interest (see e.g., Gordon 2008; Ascari, 2011).

The findings of the second phase of this research have yielded some additional insights into the process of risk selection in the UK PRI market, which were subsequently used to improve and finalise the preliminary risk selection framework. However, not all elements of the framework were possible to re-evaluate. Only the relative importance of the explicit factors is explored given the intangible nature of the implicit factors. Out of the four categories of explicit risk selection criteria (see Chapter 4), the survey results show that it is the client factors that are the most important to the UK PRI experts. The four categories are shown in hierarchal order in Figure 6.1. From the survey participants’ comments, the two key questions that PRI experts wanted to know answers to were whether a potential insured had a claims history and did it have past experience in regards to overseas investments. If an applicant is experienced in managing investments in less developed countries it is perceived to be a lower risk, everything else held constant. The first time an international investor may not have the right skill sets to mitigate and/or manage political risks. This finding should not come as a surprise, since a potential insured is the key consideration in most insurance business lines such as property, motor-auto or health insurance.

Host country factors such as the political situation and the state of the economy are ranked second to the client factors in terms of importance. A host country is one of the main considerations in the underwriting process. PRI underwriters separate their portfolios of political risks into different country books of business. Each country has a certain level of capacity allocated to it. The amount of capital allocated per a given host country depends on any number of firm internal and external factors (e.g., a size of PRI provider and the state of economy) and can vary from one country to another and from
one PRI provider to another. In addition, PRI providers usually have a formal and/or informal list of eligible host countries for which PRI coverage can be provided. Private PRI providers tend to temporarily exclude politically volatile and violent regions from the PRI coverage until the situation in a given host country or region stabilises somewhat. Public PRI providers employ a similar practice of setting eligibility requirements (see e.g., Zakariya, 1986; Gentile and Valahu, 2004). One could argue that the need for eligibility criteria in the public and private PRI sectors is driven by different objectives. Public PRI providers set their eligibility requirements in order to fulfil their public mandates (e.g., increase exports). By contrast, private PRI providers use them in order to manage their business risk and achieve profit targets. Country factors are also employed to access a level of political risk and stability in a given country. The survey findings indicate that the UK PRI market participants judge host country economic factors to be more important than host country political factors when the political situation in a host country is somewhat stable. Political factors are more important when there is a relatively higher degree of political uncertainty in a given country. The surveyed PRI experts from different jurisdictions expressed that the key factor to consider in making an underwriting decision is the country’s political stability, which is in line with the grounded theory results. A number of scholars (see e.g., Robock, 1971; Bunn and Mustafaoglu, 1978; Overholt, 1982; Henisz and Delios, 2001; Vij and Kapoor, 2007; Jarvis and Griffiths, 2007) also argue that political stability is one of the main analytical inputs in forecasting political events. The more unstable the political situation is in a given country, the greater the uncertainty in terms of future projections, which in turn can directly affect levels of risk acceptance and pricing patterns.

Both grounded theory and survey results support the fact that an industry/sector is an essential item of consideration in making an underwriting decision. Some industries are perceived to be more risky than others. For example, risks in the extracting, energy and food sectors are considered to be higher. PRI experts analyse the importance of particular industry to a given host country by assessing the following: how much tax revenue is it generating? Is it strategically important? And is it heavily regulated by the host government? The more strategically important and the more regulated a particular industry is, the higher the risk of host government intervention. Similarly, as with a host country capacity limits, PRI providers seek to limit their exposure to any one industry
by imposing capacity limits on different industries/sectors. This is needed in order to manage the systematic risk. For instance, if there is a price spike for steel in the global market for metals, this in turn can trigger host government interventions within the markets of a number of steel exporter and importer countries. A number of PRI providers have a list of industries or types of transactions that they do not cover. The rationale behind this can be to ensure that the survival and stability constraints are not being breached (see Chapter 4).

The findings indicate that policy factors are the fourth category in order of importance. PRI policies are tailor-made to meet the needs of individual insureds. In other words, the wordings of PRI policies vary from one insured to another. PRI providers need to consider a number of technical aspects before issuing a policy. According to the findings of grounded theory analysis and scenario-based survey, a tenor is one of the most important factors. A majority of private PRI insurers would not underwrite risks that are longer than seven years (Gallagher, 2011). The longer the tenor, the greater the uncertainty introduced into PRI pricing and selection processes. PRI underwriters also discriminate against a type of coverage (e.g., some political risk insurance underwriters prefer to underwrite trade political risks over project political risks \(^{16}\)) and the size of coverage requested. Most Lloyd’s PRI syndicates would not underwrite more than US$20 million per any single risk. This also manifested in the survey results, which showed that the UK PRI experts were more risk-averse and were more likely to take on smaller lines as compared with the North American PRI experts. This indirectly supports the findings of Jarzabkowski, Smets and Spee (2010), which show that the Lloyd’s of London reinsurers choose line sizes that are at variance with the market (i.e., smaller lines), whereas Bermudian reinsurance companies prefer writing large lines and if possible to take on the maximum share allowed by a potential insured. According to the survey participants’ comments analysis, deductible and its size is also one of the major considerations in the underwriting process. The rationale behind the importance of the deductible and its size is the role it plays in managing the moral hazard and adverse selection problems.

\(^{16}\)Project risks refer to long-term equity investments and tread risks are short-term trade-related transactions.
There is a need for further research in order to explore if the risk selection framework developed in this study is applicable to the other PRI markets. The survey findings suggest that there might be a number of differences between the UK and other PRI jurisdictions in relation to the risk selection process. The UK PRI market had significantly lower levels of risk acceptance compared to the other markets. This could be due to a number of reasons. Firstly, it can be that the UK PRI market has different internal risk management mechanisms in place, such as imposing maximum capacity limits per any one client, country and industry. These restrictions may not be present in other PRI markets, which in turn would allow them to take on larger shares of risks. The difference in risk acceptance levels can also arise from reinsurance arrangements. Reinsurance capacity for political risk is both limited and expensive; therefore, a number of UK PRI providers prefer to take a net underwriting position, which in turn can make them more risk-averse. In addition, PRI providers that have a reinsurance program in place can be too limited in their risk selection choices as, depending on the reinsurance arrangement, a reinsurer can have a say in what risks are acceptable and not acceptable for a portfolio of risks. Finally, the difference between the UK PRI market and other PRI markets can be due to cultural discrepancies. According to the grounded theory analysis results, the UK PRI market prefers conducting business through face-to-face interactions, during which strong personal and business relationships are formed between the underwriters and brokers. This in turn produces a sense of obligation to exchange favours on transactions. In other words, a PRI underwriter might be willing to accept a risk which he or she would otherwise decline if there is an expectation that the broker would pay back a favour by returning with more business opportunities (i.e., “the-shadow-of-the-future” effect). Again, Jarzabkowski, Smets ans Spee (2010) observe a similar behaviour in the Lloyd’s of London reinsurance market. The North America PRI market does not rely on face-to-face communication and is comfortable conducting business via electronic means. Thus, it can be that the surveyed PRI market participants perceived risks to be less acceptable due to the fact they were presented with them through an electronic platform and not by a broker with whom they have an established working relationship. In turn, the indication might be that if one wants to place a political risk in the UK PRI market, it has be done through the customary face-to-face communication channels. This can be of interest to market participants. Further research could help to explain the underlying reasons for the differences in risk acceptance levels in different PRI jurisdictions.
Finally, this study explores if there is a difference between the UK PRI market participants and specialists from PRI-related fields (i.e., non-PRI experts) with regard to the political risk selection process. As hypothesised, we find that the non-specialists have higher levels of political risk acceptance compared with the UK PRI market experts. In other words, the PRI experts were more likely to decline a risk than were the control group participants. This could be due to a number of reasons. Firstly, it can be that the UK PRI market experts measure political risks differently to the non-PRI experts. The scenario-based survey results suggest that the control group considered the host county macro political-economic factors to be relatively more important than client or industry-specific factors in the decision-making process. In comparison, the PRI experts were more inclined to focus on a micro level; that is, client and industry specific characteristics. Secondly, the PRI experts might be more aware of the negative financial consequences of their underwriting decisions, which could in turn make them more risk-averse. Finally, it could be that the UK PRI participants were more likely to decline the risk because they were asked to make a decision via electronic platform, rather than face-to-face communication; whereas for the control group this might have been of no importance. It could be of interest to retrospectively explore which knowledge, specialised or general, led to more optimal decisions.

The next section discusses the framework for political risk pricing in the UK private PRI market.

6.3 Political Risk Pricing Framework in the UK Insurance Market

The framework for political risk pricing in the UK PRI market is one of the original contributions of this research project. The findings show that traditional actuarial methods are of little use in the PRI market. This is due to a number of factors, such as a lack of publicly available data on PRI losses, which according to Coppola (2009) is a major obstacle to the actuarial model development. Even when the claims data is available, single insurance policies still cover multiple investments in a number of countries. This in turn creates an issue of homogeneity. The market overcomes these limitations by employing alternative strategies to pricing. The two most common
techniques are the rational approach, which includes a trial and error method, and the financial economic approach: integrating risk-based models such as the Economic Capital (EC) and costing models into a single pricing strategy, as well as benchmarking tools. This is in line with the existing literature. For example, Ascari (2010) argues that there are at least two approaches to pricing risks in the PRI market, such as benchmarking and trial and error methods. According to the grounded theory analysis results, in some cases UK PRI market participants employ a combined approach to pricing where both the financial economic approach and the rational approach are incorporated into the pricing process. The final framework for political risk pricing is illustrated in Figure 6.2. Political risk underwriters will choose which pricing model to apply for any given risk, depending on a number of factors such as information available, risk complexity and degree of competition for a given risk. Irrespective of which pricing approach is chosen, they all are guided by the same pricing principles that are common to the majority of insurance business lines (Black and Skipper, 2000; Ayling, 1984; Denenberg et al., 1974). These pricing principles ensure that no unfair subsidization exists of any class of insureds by any other class of insureds; that premiums are adequate to cover the benefits signed under the company’s insurance products and that they are not too excessive for competitive reasons.

**Figure 6.2:** Framework of political risk insurance pricing
The rational approach is one of the oldest pricing methods used in the UK PRI market. It involves a high degree of human judgement and bargaining. Political risk underwriters resort to the trail and error pricing method when risks they are pricing are unique and complex and for which no historical data is available or there are no adequate pricing benchmarks. According to grounded theory results, the most common benchmarking tools are Credit Default Swap (CDS) prices and sovereign bond yields, which can be employed to derive rating bands for particular exposures. The final premium rate can then be increased or decreased, depending on the type of investment (e.g., some providers apply a discount for shareholder’s loan coverage), size of investment (e.g., the larger the risk, the higher the premium), tenor (the longer the contract term, the higher the premium) and levels of portfolio aggregation in the host country (the higher the aggregation, the higher the price) (Rolfini and Paciotti, 2010, p 22). Palmer (2009) argues that the problem with benchmarking approach is that there is a lack of adequate benchmarks for different PRI products. Benchmarks like CDS prices and sovereign bond yield spreads work well for pricing sovereign non-payment policies, but are of lesser use in pricing traditional PRI products like confiscation and nationalization perils. It is possible for a given host country to be a high credit risk but to have low levels of expropriation risk. The existing PRI literature indicates that the public providers also use benchmarking techniques in pricing political risks (e.g., a number of public PRI providers use the OECD premium categories to determine minimum premium rates for different host countries). Other public providers charge a flat premium rate, which does not reflect the actual level of risk faced by the potential insured (Rolfini and Paciotti, 2010; Palmer, 2009). The biggest difference between private and public PRI providers is that the public market tends not to demand higher prices for a limited host country capacity, in comparison with the private market which is likely to push prices up (Palmer, 2009). This in turn makes public market pricing more stable, as compared with the private sector pricing.

The study findings indicate that PRI providers are moving towards the financial economic approach to pricing PRI policies. There is no one universal PRI pricing model. Most PRI providers would have their own in-house built pricing models. This change could have resulted in light of preparations for the new insurance regulation, Solvency II, which is going to require for more transparency in risk quantification and management. It was not possible to obtain access to the original in-house PRI pricing
models, as the study participants were not willing to share this kind of information due to its commercial sensitivity. However, Sundberg, Quraishi and Choudhury (2009) provide a detail description of MIGA’s pricing model for PRI policies, which they argue could also be of use to private PRI providers. PRI underwriters employ a financial economic approach to pricing risks that are relatively standardized and for which high quality of information is available. Depending on the risk and the underlying market conditions, political risk underwriters might opt for the combined approach to pricing. In this approach, upper and lower pricing bands are calculated, based on financial economic and rational pricing approaches. The final premium rate for a contract of risk acceptance is then chosen within the range of these upper and lower bands. PRI insurers have to find a price for their products which is not too high; otherwise a client will find a different way to manage a risk or not take it at all, but sufficient enough to earn the required rate of return. And this is where the *art* part comes in.

One of the aims of this study was also to explore if there are any pricing differences between the UK PRI market and other jurisdictions. This was done by asking a number of PRI experts from different markets to price the four hypothetical risk scenarios. The results show that there is no significant difference between pricing patterns of different PRI jurisdictions. This in turn implies that the pure cost of placing a political risk does not vary significantly outside the UK. Interestingly, the survey findings also showed that the UK PRI experts’ pricing patterns were not significantly different from the control group pricing. The reason behind this could be the fact that different PRI experts and experts from related PRI fields measure risks against the same benchmarks, such as CDS prices. This could explain the recurrence of similar pricing patterns in different PRI markets. The existing PRI literature indirectly supports this proposition (see e.g., Palmer, 2009; Coppola, 2009; Sundberg, et al, 2009; and Ascari, 2010; Rolfini and Paciotti, 2010). Further comparative research could help to establish if the framework for political risk pricing, which was developed in this study, is applicable to other PRI jurisdictions (e.g., North America PRI market).
6.4 Reflection on Methodological Approach

The methodological choices made in this study were guided by the main research objective, which was to conceptualise the process of political risk underwriting in the private UK insurance sector. Given the exploratory nature of the current research, an approach that allows theory to emerge from the data was the most appropriate. Burke and Onwuegbuzie (2004) encourage researchers to choose research methods that follow research questions and not vice versa. From the experiences of this research it could be also added that the research methods should be compatible with the research domain. In other words, the research design needs to take into consideration not only the research questions and methods to address them, but also a research domain. Some methodological approaches might not be acceptable or feasible in a particular research field, due to its inherent limitations (e.g., population size or confidentiality issues).

This study adopted a mixed-method approach in order to answer the five research questions. The first phase of the research involved a grounded theory analysis. This was met by a number of challenges. The UK PRI market community is very sensitive and protective of its confidentiality, which resulted in a number of delays in getting the UK PRI experts to participate in the current study. As a result, professional contacts from the London insurance market were approached and asked if they could introduce the researcher to their personal/professional PRI contacts. This helped to open some doors and get the first PRI experts to take part in the study. Once the participants were assured of total anonymity and trust was earned, they were willing to recommend and introduce the researcher to their peers and colleagues. It was decided to conduct the research interviews face-to-face, given the fact that the London PRI market prefers face-to-face communication (Jarzabkowski, Smets, and Spee, 2010). It was believed that the study participants would be less engaging via electronic communication, which could have compromised the research. A substantial amount of rich primary data was collected during the first phase of this research, which is one of the original contributions. This helped to answer research questions 1 and 2. The GTM was extremely suited for this study, as it was able to capture the importance of the implicit factors in the PRI

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17 Research question 1: How does the UK PRI market select political risks for a portfolio of risks? Research question 2: What pricing methods does the UK PRI market use?
underwriting process. This could have been missed if the quantitative approach was used to answer the research questions.

The grounded theory analysis results helped to inform the design of the scenario-based survey. The PRI premiums and claims data is not available to the public, nor it is freely shared within the PRI market community itself, due to its commercial sensitivity. As a result, the semi-experimental approach was taken to artificially generate premiums data, which in turn helped to overcome the issue of data shortage. The success of this phase of the research was highly dependent on the reliability of the scenarios. In other words, for generated pricing data to be both meaningful and useful, the scenarios had to be realistic. If the scenarios were not realistic enough, it would have negatively affected the participant’s engagement in completing the research instrument. Consequently, the London PRI experts selected were consulted on a number of occasions during the scenario development phase. Their comments were later incorporated into the final version of the research instrument. This method has been proven to work on at least two levels. Firstly, it was able to generate high quality quantitative data, which was subsequently used to answer the research questions 4 to 5\(^\text{18}\) by testing the four research hypotheses (see Chapter 5). And secondly, a number of the surveyed PRI experts commented on the four hypothetical risk scenarios in terms of what they thought were important considerations in underwriting those risks. This in turn also helped to address the research question 3\(^\text{19}\). Their comments were later included in the results, which to a degree validated and enriched the results of the grounded theory analysis. The data generated during the second phase of this research was also used to compare the UK PRI market to other PRI jurisdictions. This semi-experimental approach could be further developed and applied to fields where there is a shortage of data, or data is simply not available for the public use.

\(^{18}\)Research question 4: Does the UK PRI market have different levels of political risk acceptance as compared to other PRI markets? Research question 5: Do UK political risk underwriters price political risks differently from underwriters of other markets?

\(^{19}\)Research question 3: Which factors impact on perceptions of political risk underwriters as to what risks are acceptable?
6.5 Conclusion

In conceptualising this particular insurance market, the findings contained in this study demonstrate that the risks being insured in the PRI market are marked by their specificity and historical context and thus are difficult to assess using probability models. As a consequence, PRI providers must rely more on interpretative techniques in order to decide on whether or not to underwrite certain political risks. Grounded theory analysis shows that underwriters rely on intuition and tacit knowledge in order to arrive at the underwriting decision. For academics seeking to understand the operation of the UK PRI market, positivist methodologies will provide only a partial picture of the underwriting process in this market at best. Instead, more interpretative techniques are required to gain a complete understanding of the type of thought processes at the heart of political risk underwriting. It is clear that the risk perceptions of the market participants are central to understanding this activity. Therefore, those same participants should be the centre of any analysis of the PRI market. There is a need to understand the nature of decision-making amongst this group of insurers, hence the requirement for a well-grounded appreciation of their thought processes and the environment in which they operate. It is clear that alongside more conventional information flows, market participants rely to a large degree on how they feel about particular opportunities and that these feelings are based upon such phenomena as trust and heuristics, as well as their own tacit knowledge. The fact that market participants are expected to serve a long apprenticeship before writing political risk insurance is testament to an awareness within the industry of the importance of experience and so-called “soft skills” at this activity. Whilst there are clearly other influences at work in this process, such as portfolio management and solvency considerations, the subjective judgement of a relatively small group of individuals is at the heart of this line of insurance business; a business that assumes an important role in the promotion of FDI and contributes to the development of emerging and developing countries.
CHAPTER 7: Conclusions and contributions of research

7.1 Introduction

The main findings of this study were summarised and discussed in chapter 6. As such, the discussion in this chapter focuses on the contributions of this study to the literature and their practical and policy implications. The limitations inherent in the study are detailed and directions for future research are suggested.

7.2 Contributions of Research

This is a pioneering study in the area of political risk underwriting in the UK private insurance market, which employs research methods previously not used in the research field. It makes four main contributions to the risk and insurance literature from theoretical and methodological points of view. The key contributions of this study are initially summarised in Table 7.2.1, and then discussed in greater detail in the sections below.

There is little transparency in the PRI market. This is partly due to the fact that the sector has been largely overlooked by regulators and academics alike; moreover, the PRI market conceals more information than it reveals (Gordon, 2008; Spagnolleti and O’Callaghan, 2011). Information on PRI insurance policies, policyholders, premiums and claims history is not readily available for the public or researchers, due to sensitivity around its commercial value. The shortage of data makes it difficult for researchers to conduct any high quality research, particularly if they do not have direct access to the market participants (i.e. gatekeepers). This study was able to generate primary qualitative and quantitative data, which is one of the original contributions, through the help of established links between the industry and the Department of Accounting and Finance, University of Limerick, and social/professional networks.
Virtual professional networks are a relatively new phenomenon which are now more readily accessible to researchers. The findings of this study have shown that the use of online professional networks can be very beneficial in accessing and identifying a research domain (this is particularly the case when professional practices remain somewhat opaque).

Table 7.1: Summary of Key Contributions

<table>
<thead>
<tr>
<th>Contribution</th>
<th>Contribution Type</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>1. Framework for political risk selection process in the UK private insurance sector</td>
<td>Theoretical</td>
<td>Based upon grounded theory analysis and scenario-based survey results, an original political risk selection framework is developed which describes how the UK private PRI market selects risks for a portfolio of political risks.</td>
</tr>
<tr>
<td>2. Framework for political risk pricing in the UK private insurance sector</td>
<td>Theoretical</td>
<td>An original political risk pricing framework is developed which describes what pricing strategies the UK PRI market employs to price political risks, based upon grounded theory analysis and scenario-based survey results.</td>
</tr>
<tr>
<td>3. Innovative research design</td>
<td>Methodological</td>
<td>Previous PRI studies inferred particular knowledge flow patterns based solely on atheoretical/soft evidence. This study adopted a unique mixed-method approach, whereby the PRI underwriting process was conceptualised from the evidence emerging from the semi-structured interviews and scenario-based survey.</td>
</tr>
<tr>
<td>4. Primary PRI data</td>
<td>Data</td>
<td>This study generates primary qualitative and quantitative data which can be used for further research.</td>
</tr>
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</table>

The data generated was then analysed using the grounded theory analysis and statistical methods. The political risk selection framework is one of the main contributions of the current research project to emerge from the data analysis. A detail description of the selection framework is presented in chapter 4 and chapter 6. This is the first study to explain what criteria political risk underwriters use when selecting risks for a portfolio.

20 LinkedIn site was officially launched on May 5, 2003. It grew from 4,500 members in 2003 to 161 million members in 2012 (LinkedIn, 2012).
of risks in the UK private insurance sector (Baublyte, Mullins and Garvey, 2012). Indeed, one could see the findings presented in this study as a guide to the PRI business. But more importantly, the findings add to the transparency of the PRI market, which could be of great interest to regulators, insurance firms and buyers of PRI products. Buyers of PRI policies can use the risk selection criteria as described in chapters 4 and 6 to assess their chances of acquiring a PRI policy, or to see how PRI underwriters arrive at an appropriate rate\(^{21}\).

The second contribution of this study is the development of a framework for political risk pricing in the UK private PRI market. The pricing framework is explained in chapter 4 and chapter 6. This study differs in three ways from existing PRI studies that discuss political risk pricing. Firstly, it is the first study to use well-established research methods to analyse the process of PRI policy pricing. Secondly, the previous studies focused on the public PRI market pricing practices, whereas the current study is devoted to understanding private PRI market pricing strategies (see e.g., Palmer, 2009; Coppola, 2009; Sundberg, et al, 2009; and Ascari, 2010). Finally, the study utilised the scenario-based survey in order to compare the pricing patterns of different PRI markets, which were found to be no different among the five surveyed PRI markets. The framework explains the underlying pricing principles and strategies, as well as when particular pricing strategies (e.g., rational approach to pricing) are preferred over others (e.g., financial approach to pricing). From a regulator’s point of view, the findings are interesting as they show that even though there is an obvious move towards a risk-based approach to pricing, i.e. more scientific pricing methods, there are still a number of PRI providers that price political risk based more on personal judgement and experience.

The third contribution is that this is the first study to have used a mixed-method approach of qualitative and quantitative methods in the PRI field. The first stage of the research involved the grounded theory analysis. The method is commonly used in sociology, medicine and/or psychology, but it has not really been adopted in the area of non-life insurance. The findings of grounded theory have come to demonstrate the versatility of this method. The second stage of this study involved the scenario-based

\(^{21}\) For example, if a potential insured applies for a PRI contract with 5-year duration rather than 7-year duration, it makes a risk more acceptable from the insurer’s point of view. This knowledge could give greater bargaining power to buyers of PRI products when it comes to determining pricing and terms and conditions of a contract.
survey analysis in order to answer the research questions 3 to 5, and in doing so to supplement the findings of the grounded theory. This semi-experimental approach has been proven to work well for research areas where there is a shortage of data or where it is not available due to confidentiality/privacy restrictions and constraints. Indeed, this study was able to generate premium data by asking PRI experts to select and price the hypothetical risk scenarios in a manner that did not breach participants’ confidentiality concerns, nor did it ask them to disclose any commercially sensitive information. This said, it did provide valuable insight into the pricing of PRI policies. The scenario-based survey approach could be further developed as a research tool to generate and collect primary data in a way that does not violate existing confidentiality agreements.

As has already been mentioned, there is little transparency in the PRI field. In fact, there are only a few sources that provide valuable data on the PRI business. Organisations like OPIC, MIGA, ONDD and the Berne Union publish some useful and informative data on PRI claims and premiums. However, there are a number of issues with the existing secondary PRI data. The OPIC claims history is very specific to the agency and cannot be used to make any general conclusions about the PRI industry itself. The Berne Union statistics is too general, and its main purpose is to illustrate industry trends. In other words, it does not report underwriting results per any one individual member. Overall, most existing data comes from public PRI providers and therefore is of limited use in researching the private PRI market. This in turns leads to the final contribution of this study; that is the primary data which was generated throughout the course of this study. This data comes from the private PRI market and that can be used for further research, as well as to document the development of the private PRI market.

**7.3 Implications for Practice and Policy**

The findings of this study are of benefit to insurance providers wishing to open a PRI operation in the UK private insurance market. They could be also of interest to the existing PRI providers seeking to improve their PRI underwriting models. According to study participants, the PRI mechanism is not very well understood outside the immediate PRI field and in some cases within the wider PRI provider’s organisation (the boards of directors of PRI providers do not necessarily have an expertise in the area). This could be due to the lack of market knowledge exchange and flow between
insurance firms, as well as within a PRI provider’s organisation itself. PRI expertise is treated as intellectual property which is closely guarded by the market participants. This in turn serves as one of the major market entry barriers. An insurance firm seeking to enter the PRI market first would need to acquire know-how expertise which is limited to a small number of experts. The results presented in this study could serve as a handbook to the PRI business. This is the first independent study to methodologically describe the process of political risk underwriting, which in turn serves to reduce information asymmetry in the UK PRI market.

In addition, some possible policy implications may be inferred from this research study. The PRI is a profitable line of business, which so far has escaped the attention of regulators (Spagnolleti and O’Callaghan, 2011). This could be due to the fact that PRI falls under the broad umbrella of property insurance, which, given its relatively low trading volume, can go unnoticed by regulators. The supervision and regulation of PRI business is thus left to a board of directors and management team. The consequence of this is a lack of transparency of PRI market operations. One could also argue that it can lead to lower policyholder protection. This highlights the need for greater regulation and transparency in the PRI field.

Under Solvency II, insurance regulation, PRI providers would be asked to demonstrate to their regulators that the underwriting models they use are sufficiently complete, accurate and appropriate for their business. This would lead to higher market transparency, which in turn could contribute towards PRI market development and innovation. However, given the relative absence of quantitative models and the importance of intangible factors (such as pre-existing relationship and heuristics), providing regulators with clear risk metrics for this line of business may prove to be problematic.

7.4 Limitations and Suggestions for Future Research

While the steps taken to ensure the rigour of this research were extensive and exhaustive, it should be acknowledged that there are some inherent limitations to the study. These can be categorised into methodological and research domain-specific limitations.
Methodological limitations relate to general reservations regarding reliability and generalizability of the study findings. Theory is not the formulation of some discovered elements of pre-existing reality ‘out there’; rather it is an interpretation made from a given perspective (Strauss and Corbin, 1994). Therefore, it is important to recognise that theories can be temporally tied. They should always be considered as conditional and subject to future re-evaluation. The reliability of conclusions made from this study may be temporally constrained, given the fact that the UK PRI market is constantly reacting and adjusting to the wider political, economic, social, legal and cultural circumstances as well as technological innovation. The PRI underwriting mechanism can change over time as more data/information becomes available and/or as a result of technological innovation. In addition, this study was primarily focused on the UK private PRI market, which may limit the generalizability of the findings. That said, the UK PRI market is the largest centre for this class of insurance business.

This study also encountered a number of limitations relating to the research subject itself. The PRI market is a small and closed community which is highly sensitive and protective of its privacy. Therefore it was very difficult to persuade UK PRI experts to take part in the current research project. The study participants had to be reassured of complete confidentiality. This in turn resulted in a number of delays. Statistical analysis of the PRI market was also not feasible, as PRI providers were not willing to share their claims and premiums data. The PRI claims and premiums data is highly commercially sensitive, the disclosure of which can result in the loss of competitive advantage of a PRI provider. It is no understatement to say that the shortage of data (including the existing PRI literature) and the secrecy of the PRI market represented the most serious obstacles in this research project.

There is much scope for future research to be conducted in the area of PRI. This study only focused on the UK private PRI market. It is likely that the political risk selection and/or pricing frameworks developed in the present study would not be applicable to other PRI markets in exactly the same manner. Future research could show that there are a number of underwriting differences between separate PRI markets caused by different factors (e.g., cultural and legal environments). For example, it may be that the implicit risk selection criteria do not play an important role in the North America PRI market. This could be the consequence of a difference in preference in the style of
conducting business (e.g., face-to-face communication versus electronic communication). The current research project has taken the first step in understanding the process of political risk underwriting in the insurance sector. Further research should focus on comparative work to examine whether or not the UK PRI market is idiosyncratic or conforms to industry norms.
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Appendix A: Letter of Introduction (Sample)

Dear XX,

I am Lijana Baublyte a PhD student at the University of Limerick. I got your contact details from XX.

I believe my research would benefit numerously from your knowledge and experience in the field of political risk underwriting. I would like to set up an interview with you at your convenience to talk more about your work and your perceptions on the PRI business.

If you are available for an interview, I would be happy to schedule a time with you at your convenience.

I look forward to hearing from you.

Kind regards,

Lijana Baublyte
Appendix B: Interview Consent Form

The study:
We are interested in the perception, underwriting and management of political risk within insurance market. You are invited to participate in the interview to provide answers which best fit your own beliefs and experience.

Purpose:
This interview is designed to get further insight into the political risk insurance. To further this aim, you are asked about the political risk insurance generally and more specifically about your professional experience as the political risk underwriter.

Procedure:
If you agree to take part in this study, you will be interviewed for the purposes of the study named above. Your participation will take about an hour (which includes reading and signing the consent form and introductory explanations of the procedure provided by the researcher).

Benefits:
This study will contribute to the body of knowledge in the area of risk and insurance. It will also contribute to the generation of further studies that will advance the aims of gaining insight into the political risk insurance.

Risks:
There are no known risks associated with this study. If you should at anytime feel yourself upset or uncomfortable, you may stop participating in the study. If you do not wish to answer any questions, you have the right to refuse to answer the question or withdraw from the interview at any time.

Privacy:
Anonymity of the research subjects will be strictly maintained by the researchers. Your name, and any other identifying information, will only appear on this form. Your personal identity and your employer identity will not be used or cited or otherwise disclosed, in the study. You have the right to refuse to be electronically recorded.

If you have any questions about this study, you are free to contact the researcher. If you have any questions about the rights of a researcher, you are free to contact the Chair of KBS Research Ethics Committee: Kemmy Business School, University of Limerick, Limerick, Ireland.

If you understand the terms and agreements described and you agree to participate in this study, please sign below.

Participant’s signature ___________________ Researcher’s signature ___________________ Date ___________________
Appendix C: Interview Questions

Interview questions:

1. Could you describe your role in the company?
2. Could you define your role as a political risk underwriter/broker?
3. How would you define political risk?
4. Are there close links/associations between political risk and any other risk?
5. What criteria do you use for political risk selection?
6. Do you interact/communicate with actuaries during the risk selection/pricing processes?
7. What role does the personal/professional experience play in the PRI market?
8. Is the business conducted through a broker or directly with a client?
9. Who is responsible for developing underwriting policy?
10. How would you describe ‘good’/’bad’ political risks?
11. What methods do you use for pricing political risks?
Appendix D: Research Instrument

Survey of Political Risk Underwriting Decision Making

University of Limerick
Cargill is a Multinational Corporation headquartered in the US, which specialises in the production and marketing of food, agricultural, industrial and financial products and services. It was founded in 1865 and currently employs 130,000 people in 63 countries. The company operates 32 grain elevators along the Mississippi, Ohio, Minnesota and Illinois rivers. These facilities ship approximately 10 MMT grain per year. At any one time, the company has up to 350 vessels chartered across the world’s oceans. Its earnings for the 2010 fiscal year totalled $2.69 billion, which is a 35% increase on the previous fiscal year. Cargill actively engages in Corporate Social Responsibility (CSR) by means of committing itself to its business conduct, the environment, people and communities.

Cargill has agreed to sell 30,524 MT of wheat of different grade, with an average price of $325 per MT, to the Iraqi Ministry of Agriculture. The overall size of the transaction is $10,000,000 and delivery of the grain is contingent on the receipt of a letter of credit from the Trade Bank of Iraq issued on behalf of the Iraqi Ministry of Agriculture.

Cargill wants to get a PRI policy which covers failure to honour a letter of credit. The policy should cover a period of 90 days and the desired size of coverage is US$10 million.

You are a political risk underwriter and you need to decide whether or not you should accept this risk on your company’s behalf.
1. Rate the following 10 factors in terms of importance in making the underwriting decision

<table>
<thead>
<tr>
<th>Factor</th>
<th>Very important</th>
<th>Important</th>
<th>Moderately important</th>
<th>Of little importance</th>
<th>Unimportant</th>
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</thead>
<tbody>
<tr>
<td>1. The potential insured is in a strong financial position</td>
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<td>2. Iraq’s total reserves including gold amount to 54% of GDP</td>
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<td>3. The US will withdraw all of its forces (approximately 50,000 troops) from Iraq by the end of 2011.</td>
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<td>4. The tenor for the requested policy is 90 days.</td>
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<td>5. Your facility to retrocede part of the risk</td>
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<td>6. The next Iraqi national election is at least three years away.</td>
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<td>7. Iraqi GDP growth rate is 0.8% (2010 est.)</td>
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<td>8. Whether the potential insured has a claims history using PRI and/or Credit insurance</td>
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<td>9. Iraq is unrated by S&amp;P or Moodys</td>
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<td>10. The fact that the potential insured is an American company</td>
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2. Select the four items, from the above 10 items, you consider to be of most importance in making the underwriting decision (Items are identified by their number from 1 to 10).

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<tr>
<th>Most important factor</th>
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3. What line size would you give?

- 0
- up to $5m
- $5 – 10m
- $10-20m
- $20 – 40m
- More than 40m

4. Suggest what would be an appropriate rate for this risk?

- Up to 0.5%
- 0.51 – 1%
- 1.01 – 1.5%
- 1.51 – 2%
- 2.01 – 2.5%
- 2.51 – 3%
- Over 3%
RWE Coal International (RWECI) is a coal mining and production company focused on building a balanced portfolio of assets in South East Asia. As one of Germany’s largest coal producers RWECI has an estimated revenue of US$1.9bn in 2010. It was established in 1984 by coal industry personnel with substantial experience in coal mining and production. The company was subsequently listed on the Frankfurt Stock Exchange in early 1990. RWECI has an outstanding reputation for probity and integrity.

The company is considering the acquisition of a coal mining operation site worth US$300 million in Indonesia. It has contacted BPL Global, political risk broker, and asked to place their US$300 million risk in the London insurance market. The company was very specific and asked that the following perils be covered in the PRI policy: expropriation, confiscation, nationalization, embargo, cancellation of export licenses, currency inconvertibility, non-transfer and political violence. The broker contacted MIGA which agreed to insure US$250 million for 2% premium rate. Consequently, BPL Global have approached you trying to place the remaining US$50 million.

You are a political risk underwriter and you need to decide whether or not you should accept this risk on your company’s behalf.

<table>
<thead>
<tr>
<th>FOREIGN COUNTRY</th>
<th>Indonesia</th>
<th>RATING</th>
<th>BB</th>
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<tbody>
<tr>
<td>INSURED’S COUNTRY</td>
<td>Germany</td>
<td>RATING</td>
<td>AAA</td>
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<td>INSURED</td>
<td>RWE Coal International (RWECI)</td>
<td>RATING</td>
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<tr>
<td>SECTOR</td>
<td>Mining and extraction</td>
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<td>TYPE</td>
<td>Investment and property-related political risks</td>
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<td>LIMIT (USD)</td>
<td>50,000,000</td>
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<td>TENOR (YEARS)</td>
<td>5 years</td>
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<tr>
<td>BROKER</td>
<td>BPL Global</td>
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</table>
1. Rate the following 10 factors in terms of importance in making the underwriting decision

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<thead>
<tr>
<th>Factor</th>
<th>Very important</th>
<th>Important</th>
<th>Moderately important</th>
<th>Of little importance</th>
<th>Unimportant</th>
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<tbody>
<tr>
<td>1. Indonesia has a market-based economy in which the government plays a significant role.</td>
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<td>2. The World bank downgraded Indonesia’s rank in Protecting Investors from 41 to 44 in 2011 (out of 183 countries, 183rd rank being the worst)</td>
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<td>3. Indonesia has positive GDP growth: 4.5% (2009), 6.1% (2010) and 6.2% (2011)</td>
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<td>4. Through the ups and downs of Indonesia’s economy in recent years, Germany remained its most important European trade partner.</td>
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<td>5. Indonesia is a member of the WTO and the International Centre for Settlements of Investment Disputes (ICSID).</td>
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<td>6. The fact that the risk is in the mining and extraction sector.</td>
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<td>7. The potential insured engages in corporate social responsibility and is committed to contributing to the local community’s wellbeing.</td>
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<td>8. The host country’s credit rating</td>
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<td>9. The fact that MIGA is co-insuring the risk</td>
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<tr>
<td>10. Your facility to retrocede part of the risk</td>
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</tbody>
</table>

2. Select the four items, from the above 10 items, you consider to be of most importance in making the underwriting decision (Items are identified by their number from 1 to 10)

<table>
<thead>
<tr>
<th>Most important factor</th>
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<td>Second most important factor</td>
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</table>

3. What line size would you give?

- [ ] 0
- [ ] up to $5m
- [ ] $5 - 10m
- [ ] $10-20m
- [ ] $20 – 40m
- [ ] More than 40m

4. Suggest what would be an appropriate rate for this risk?

- [ ] Up to 0.5%
- [ ] 0.51 – 1%
- [ ] 1.01 – 1.5%
- [ ] 1.51 – 2%
- [ ] 2.01 – 2.5%
- [ ] 2.51 – 3%
- [ ] Over 3%
Barclays Capital investment bank is considering issuing a loan of US$100 million to the ministry of finance of the Republic of Kazakhstan. The loan is to be used to finance an infrastructure project in Kazakhstan. More precisely, the government is planning to build a new motorway from Balqash city to Almaty city, which is the largest city in Kazakhstan. Barclays Capital has reached its Kazakhstan country limit and therefore wants to insure US$30,000,000 of the loan against the Kazakh government’s non-payment risk. The bank is ready to pay a premium of 70% of its bank margin for the contract of acceptance.

Barclays is a major global financial services provider engaged in retail banking, credit cards, corporate and investment banking and wealth management with an international presence in Europe, the Americas, Africa and Asia. With over 300 years of history and expertise in banking, Barclays operates in over 50 countries and employs over 147,000 people. Barclays moves, lends, invests and protects money for over 48 million customers and clients worldwide.

You are a political risk underwriter and you need to decide whether or not you should accept this risk on your company’s behalf.
1. Rate the following 10 factors in terms of importance in making the underwriting decision

<table>
<thead>
<tr>
<th>Factor</th>
<th>Very important</th>
<th>Important</th>
<th>Moderately important</th>
<th>Of little importance</th>
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<tbody>
<tr>
<td>1. Kazakhstan President Nursultan Nazarbayev was re-elected in 2010 for another seven-year term</td>
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<td>3. Current market prices for Credit Default Swap (CDS)</td>
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<td>4. Your facility to retrocede part of the risk</td>
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<td>5. Kazakhstan’s GDP is US$ 142 billion</td>
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<td>6. The reason why Barclays wants to buy coverage</td>
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<td>7. Whether you have had previous dealings with this bank</td>
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<td>8. Whether you think the bank’s proposed premium is adequate for you to accept the risk</td>
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<td>9. The host country’s credit rating</td>
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<tr>
<td>10. The fact that the potential insured is a well-known bank</td>
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</table>

2. Select the four items, from the above 10 items, you consider to be of most importance in making the underwriting decision (Items are identified by their number from 1 to 10).

<table>
<thead>
<tr>
<th>Most important factor</th>
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</tbody>
</table>

3. What line size would you give?

- [ ] 0
- [ ] up to $5m
- [ ] $5 – 10m
- [ ] $10-20m
- [ ] $20 – 40m
- [ ] More than 40m

4. Suggest what would be an appropriate rate for this risk?

- [ ] Up to 0.5%
- [ ] 0.51 – 1%
- [ ] 1.01 – 1.5%
- [ ] 1.51 – 2%
- [ ] 2.01 – 2.5%
- [ ] 2.51 – 3%
- [ ] Over 3%
LUKOIL is the third largest non-state publicly traded oil company in the world with proven reserves of hydrocarbons. It is a leading company among Russian oil companies in terms of openness and transparency and is the first Russian company to receive full listing on the London Stock Exchange. LUKOIL group’s sales are in excess of US$100 billion and its net income is over US$9 billion annually.

LUKOIL’s mindfulness of the importance and the benefits of renewable energy have led to the establishment of the ‘LUKOIL-Ecoenergo’ subsidiary whose main purpose is to carry out renewable energy projects. The subsidiary considers projects which use solar, wind, hydro and geothermal energy. Further, LUKOIL is actively pursuing partnerships with international companies on cooperation in the field of renewable energy. LUKOIL-Ecoenergo is currently cooperating with ERG Renew, an Italian company, on the development of renewables.

LUKOIL- Eco Energo and the Saudi Electricity Co (SEC) are planning to start Farasan Solar Park, a 400 KW solar power plant, located on Farasan island in southwest Saudi Arabia. Under the LUKOIL – Saudi Arabian agreement, LUKOIL will own 80% of the project for up to 15 years with the remaining 20% being held by SEC. After 15 years the assets will be reassigned in total to SEC.

LUKOIL is looking for a PRI policy covering traditional political risk perils (CEN), currency inconvertibility, non-transfer, contract frustration, license cancellation and political violence. The tenor requested is 10 years and the coverage is US$170,000,000.

You are a political risk underwriter and you need to decide whether or not you should accept this risk on your company’s behalf.
1. Rate the following 15 factors in terms of importance in making the underwriting decision

<table>
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<tr>
<th>Factor</th>
<th>Very important</th>
<th>Important</th>
<th>Moderately important</th>
<th>Of little importance</th>
<th>Unimportant</th>
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<tbody>
<tr>
<td>1. Saudi Arabia is a monarchy with a Council of Ministers and a Consultative Council, where formal political parties are not recognized and have no legal status.</td>
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<tr>
<td>2. Saudi Arabia is a member of the International Centre for Settlements of Investment Disputes (ICSID).</td>
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<td>3. Saudi Arabia’s legal system originates from English common law.</td>
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<td>4. Saudi Arabia’s current account surplus was US$22 billion in 2009.</td>
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<td>5. The potential insured’s home country is Russia</td>
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<td>6. The risk is in the energy sector</td>
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<td>7. The desired size of coverage</td>
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<td>8. Your facility to retrocede part of the risk</td>
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<td>9. The expected trend in the global price of oil</td>
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<td>10. Russia and Saudi Arabia compete for oil market share.</td>
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2. Select the four items, from the above 10 items, you consider to be of most importance in making the underwriting decision (Items are identified by their number from 1 to 10).

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<th>Factor</th>
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3. What line size would you give?

- 0
- up to $5m
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- $10-20m
- $20 – 40m
- More than 40m

4. Suggest what would be an appropriate rate for this risk?

- Up to 0.5%
- 0.51 – 1%
- 1.01 – 1.5%
- 1.51 – 2%
- 2.01 – 2.5%
- 2.51 – 3%
- Over 3%
You have now completed the survey

Sincere thanks for your time and for your help with our research

Please seal the research materials in the envelope provided to ensure confidentiality and either hand the envelope back to the person in your company/organisation who has been identified as the contact person for the purposes of this study or post the envelope directly back to the researchers. If you would like to receive a copy of the research report, please fill in your postal details on the ‘Research Report Request’ page provided and return the page to the researchers separately from the questionnaire.
Contract of Guarantee for Equity Investments

between the

Multilateral Investment Guarantee Agency

and

[Guarantee Holder]

This draft document is subject to MIGA’s approval, and as such cannot be considered a contract or an offer to enter into a contract. Only the document executed by MIGA, as approved by MIGA’s senior management and the Guarantee Holder, will contain the terms and conditions that shall bind them. Until this document is executed by MIGA and the Guarantee Holder, neither MIGA nor the Guarantee Holder intends to be bound by its terms and conditions.
Contract of Guarantee for Equity Investments

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Contract of Guarantee ("Contract") between the Multilateral Investment Guarantee Agency ("MIGA") and [__________] (the “Guarantee Holder”), a company organized and existing under the laws of [__________].

CLAUSE 1. Project Enterprise: [__________].

CLAUSE 2A. Investment Project: [__________].

CLAUSE 2B. Host Country: [__________].

CLAUSE 3. Guarantee Currency: [__________].

CLAUSE 4A. Total Equity Investment of the Guarantee Holder: [Amount in Guarantee Currency.]

CLAUSE 4B. Guaranteed Investment:

Shares: [_______ shares of par value _______ each, representing a ____% ownership interest in the Project Enterprise, provided that such number of shares shall be adjusted to reflect a stock split, stock dividend or similar measure.]

Tangible Assets: [Not applicable.] [Describe.]

Ownership Interest: [Not applicable.] [Describe.]
CLAUSE 5. Contract Period: The [__]-month periods ending on the [__] day of each [_____] and [____], commencing with the period starting on the Effective Date and ending on [____].

CLAUSE 6. Guarantee Period: The period commencing on the Effective Date and ending on [____].


CLAUSE 8. Waiting Period: Transfer Restriction: Inconvertibility [60] continuous days. Inability to Transfer [60] continuous days.
Expropriation: Expropriation of Investment [180] continuous days. Expropriation of Funds [60] continuous days.
Breach of Contract: Arbitral Award Default [180] continuous days. Denial of Recourse [180] continuous days.

CLAUSE 9A. Percentage of Cover: [90]%

CLAUSE 9B. Percentage of Self-Insurance: [10]%

Total: 100%

CLAUSE 10A. Current Amount of Guarantee: [Amount in Guarantee Currency], as adjusted in accordance with Article 15 of the General Conditions, and reflected in a revised Special Conditions.
CLAUSE 10B. Sublimit of Guarantee: Notwithstanding Clause 10D, the maximum aggregate amount of compensation payable by MIGA under Temporary Loss of Income is [_______].

CLAUSE 10C. Standby Option Amount: [Amount in Guarantee Currency.] [Not applicable.]

CLAUSE 10D. Maximum Aggregate Liability: [Amount in Guarantee Currency.]

CLAUSE 11A. Annual Premium Rate: [____]%

CLAUSE 11B. Total Premium for the First Contract Period: [Amount in Guarantee Currency], payable on or before the Initial Premium Due Date.

CLAUSE 12A. Annual Standby Option Fee Rate: [____]% [Not applicable.]

CLAUSE 12B. Standby Option Fee for the First Contract Period: [Amount in Guarantee Currency], payable on or before the Initial Premium Due Date. [Not applicable.]

CLAUSE 13A. Annual Facility Fee Rate: [____]% [Not applicable.]

CLAUSE 13B. Facility Fraction: [______]. [Not applicable.]

CLAUSE 13C. Facility Fee for the First Contract Period: [Amount in Guarantee Currency], payable on or before the Initial Premium Due Date. [Not applicable.]

CLAUSE 14A. Total Amount Due for the First Contract Period: [Amount in Guarantee Currency], payable on or before the Initial Premium Due Date.

CLAUSE 14B. Initial Premium Due Date: [Date no later than the date falling 15 calendar days after the Effective Date.]

CLAUSE 15. Deductible:
Transfer Restriction: [Amount in Guarantee Currency.][None.]
Inconvertibility [Amount in Guarantee Currency.][None.]
Inability to Transfer
Expropriation: [Amount in Guarantee Currency.][None.]
Expropriation of Investment [Amount in Guarantee Currency.][None.]
Expropriation of Funds
War and Civil Disturbance:  
Loss of Assets  [Amount in Guarantee Currency.][None.]
Temporary Loss of Income  [Amount in Guarantee Currency.][None.]
Permanent Loss of Use  [Amount in Guarantee Currency.][None.]

Breach of Contract:  
Arbitral Award Default  [Amount in Guarantee Currency.][None.]
Denial of Recourse  [Amount in Guarantee Currency.][None.]

CLAUSE 16.  Effective Date:  

CLAUSE 17.  Notice Addresses:

MULTILATERAL INVESTMENT GUARANTEE AGENCY  [GUARANTEE HOLDER]
1818 H Street, NW
Washington, DC 20433
United States of America

Attention:  Contract Management & Portfolio Services
MIGA Operations
Facsimile:  +1 202-522-2630
Telephone:  +1 202-473-0610

[Name]
[Title]
[Number]
[Number]
IN WITNESS WHEREOF, MIGA and the Guarantee Holder, acting through their duly authorized representatives, have caused this Contract to be signed in their respective names. This Contract is deemed made in Washington, DC, United States of America, and will come into force on the Effective Date upon its execution by both parties, subject to: (a) receipt by MIGA of payment in full of the Total Amount Due for the first Contract Period on or before the Initial Premium Due Date; and (b) no later than seven (7) calendar days after the Effective Date, the receipt by MIGA of a counterpart of this Contract which shall have been executed by the Guarantee Holder on or before the Effective Date.

MULTILATERAL INVESTMENT GUARANTEE AGENCY

By: (signature)
Izumi Kobayashi
Executive Vice President
Authorized Representative (name and title)
Washington, DC [ ]
(place and date)

[GUARANTEE HOLDER]

By: (signature)
Authorized Representative (name and title)
City [ ]
(place and date)
ARTICLE 1. APPLICATION AND INTERPRETATION

1.1 The Special Conditions (Part I), the General Conditions (Part II), the Amendments (Part III), if any, the Standby Option (Part IV), and the Annexes, if applicable, shall form the entire Contract of Guarantee for Equity Investments.

1.2 The capitalized terms herein are used as they are defined under Article 2. Such defined terms in the singular shall include the plural and vice versa.

1.3 The terms “Corrupt Practice”, “Coercive Practice”, “Collusive Practice”, “Fraudulent Practice” and “Obstructive Practice” shall be interpreted in accordance with the Anti-Corruption Guidelines attached as Annex 1.

1.4 Unless otherwise stated, all references herein to Articles, Sections, Subsections and Annexes are to those of these General Conditions.

1.5 Notwithstanding any other provision herein, if any obligation to be performed under this Contract falls on a day that is not a Business Day, such obligation shall be performed on the next succeeding Business Day.

1.6 This Contract is based on the Guarantee Holder’s representations and warranties made to MIGA herein.

ARTICLE 2. DEFINITIONS

“Anti-Corruption Guidelines” means the document entitled “MIGA’s Anti-Corruption Guidelines” attached as Annex 1, which guidelines clarify how the terms Corrupt Practice, Coercive Practice, Collusive Practice, Fraudulent Practice, and Obstructive Practice shall be interpreted and enforced.

“Application for Guarantee” means the Definitive Application for Guarantee, including all attachments and any updates thereto, delivered to and filed with MIGA by the Guarantee Holder before the Effective Date.

“Arbitral Award Default” means the Covered Risk described as a subset of Breach of Contract in Subsection 6.1(a).

“Award” means a final, non-appealable and binding decision rendered on the merits by a competent arbitral tribunal, court of law or similar judicial forum in accordance with the Dispute Resolution Procedure which:

(a) is for a specified monetary amount; and

(b) has been rendered pursuant to a breach of a Contractual Obligation or repudiation of such Project Agreement by the Host Government.
“Book Value” means the value of any assets of the Project Enterprise calculated in accordance with International Financial Reporting Standards and determined by MIGA in accordance with the audited accounts of the Project Enterprise.


“Business Day” means a day on which banks are open for business in New York, New York, USA.

“Business Income” means the net profit before depreciation, amortization, and income taxes of the Project Enterprise arising from the Investment Project to which the Guarantee Holder would have been entitled but for the Temporary Loss of Income.

“Claim” means an application submitted in writing by the Guarantee Holder to MIGA for payment of compensation for a Loss under the Contract.

“Coercive Practice” means impairing or harming, or threatening to impair or harm, directly or indirectly, any person or the property of a person to influence improperly the actions of a person.

“Collusive Practice” means an arrangement between two or more persons designed to achieve an improper purpose, including to influence improperly the actions of another person.

“Continuing Expenses” means normal expenses that are usual to the operations of the Project Enterprise prior to the Loss and are necessarily and unavoidably incurred by the Project Enterprise during the Indemnity Period. Continuing Expenses include, but are not limited to, salaries and ordinary payroll, expenses relating to the use of premises and utilities, taxes, other fixed expenses and the unavoidable portion of variable expenses, and debt service payable (in the scheduled amounts as and when due, without regard to any acceleration or mandatory prepayment) during the Indemnity Period from loans made to the Project Enterprise prior to the Loss (but excluding any amounts payable directly to the lender pursuant to another insurance policy or any other source).

“Contract” means the Contract of Guarantee, which includes the Special Conditions (Part I) and these General Conditions (Part II), and which may include the Amendments (Part III), the Standby Option (Part IV), and the Annexes.

“Contract Period” means:

(a) the period commencing on the Effective Date and ending on the first date specified in Clause 5 of the Special Conditions; and

(b) each successive period ending on the dates specified in Clause 5 of the Special Conditions or, if earlier, the end of the Guarantee Period.

“Contractual Obligation” means an obligation or obligations to be performed by the Host Government under a Project Agreement for the benefit of the Project Enterprise or the Guarantee Holder which are covered against Breach of Contract under Article 6 and specified in Annex 2.

“Control” means, for purposes of the defined terms “Host Government” and “State-Owned Enterprise”, ownership of a majority of the voting capital of another entity or the power otherwise
to direct the management, policies or composition of the board of directors (or equivalent body) through ownership of voting capital, by contract or otherwise.

“Convention” means the Convention Establishing the Multilateral Investment Guarantee Agency dated October 11, 1985, as amended, and as in force on the Effective Date.

“Corrupt Practice” means the offering, giving, receiving or soliciting, directly or indirectly, of anything of value to influence improperly the actions of another person.

“Covered Risk” means any event described in the relevant sections of the General Conditions for any risk specified in Clause 7 of the Special Conditions.

“Current Amount of Guarantee” means, for any Contract Period, the sum of:

(a) the amount specified in Clause 10A of the Special Conditions; and

(b) the aggregate amounts validly transferred from the Standby Option prior to the commencement of such Contract Period in accordance with Section 15.3,

less the aggregate amounts reduced from the Current Amount of Guarantee in accordance with Section 15.2, which is the maximum aggregate amount of compensation payable by MIGA under the Contract for such Contract Period, irrespective of the number of Losses.

“Date of Loss” means, with respect to a Covered Risk of:

(a) Transfer Restriction, the date of the action or inaction constituting the Covered Risk for which compensation is claimed as described in Article 3;

(b) Expropriation, the date of the action or inaction constituting the Covered Risk for which compensation is claimed as described in Article 4;

(c) War and Civil Disturbance,

(i) with respect to Loss of Assets, the date that the destruction, disappearance, or damage occurs,

(ii) with respect to Temporary Loss of Income, the date of the suspension or interruption of project construction or operations of the Investment Project,

(iii) with respect to Permanent Loss of Use, the date as of which the Project Enterprise is unable to conduct operations essential to its overall financial viability, in each case as a direct and immediate result of the events described in Section 5.1; and

(d) Breach of Contract,

(i) with respect to Arbitral Award Default, the date of the Award, and

(ii) with respect to Denial of Recourse, the date of the commencement of the action constituting the Covered Risk for which compensation is claimed as described in Subsection 6.1(b).

“Deductible” means the amount or amounts specified in Clause 15 of the Special Conditions for which the Guarantee Holder may not file a Claim for a given Loss.
“Denial of Recourse” means the Covered Risk described as a subset of Breach of Contract in Subsection 6.1(b).

“Development Effectiveness Indicators” means the set of development metrics to be provided by the Guarantee Holder to MIGA and specified in Annex 3B.

“Dispute Resolution Procedure” means the arbitration, adjudication or other dispute resolution procedure specified in the applicable Project Agreement.

“Effective Date” means 12:01 AM, Washington, DC time, on the date specified in Clause 16 of the Special Conditions as the date on which the Contract becomes effective.

“Expropriation” means the Covered Risks described in Section 4.1.

“Expropriation of Funds” means the Covered Risk described as a subset of Expropriation in Subsection 4.1(b).

“Expropriation of Investment” means the Covered Risk described as a subset of Expropriation in Subsection 4.1(a).

“Extraordinary Expenses” means:

(a) expenses used to expedite restoration of the productive capacity of the Investment Project by enabling construction or operation to resume earlier than if such expenses were not incurred; and

(b) any expenses incurred by the Guarantee Holder to continue the operations of the Project Enterprise at other premises or replace the production of the Project Enterprise by any other means, including relocation expenses and costs to equip and operate the replacement or temporary locations; provided, however, that expenses referred to in (a) and (b) above shall only be deemed to be Extraordinary Expenses to the extent such expenses have reduced the amount of compensation for Temporary Loss of Income that otherwise would have been payable by MIGA.

“Facility Fee” means:

(a) for the first Contract Period, the amount payable by the Guarantee Holder specified in Clause 13C of the Special Conditions; and

(b) for each subsequent Contract Period, the amount payable by the Guarantee Holder calculated by taking the product of the following amounts:

(i) the sum of the Current Amount of Guarantee and the Standby Option Amount as of the first day of such Contract Period;

(ii) the Facility Fraction;

(iii) the annual Facility Fee rate specified in Clause 13A of the Special Conditions; and
(iv) the actual number of days in such Contract Period, calculated using a 365-day year.

and dividing the product so obtained by 365.

“Facility Fraction” means the portion of the Maximum Aggregate Liability subject to reinsurance by MIGA, as specified in Clause 13B of the Special Conditions.

“Fraudulent Practice” means any act or omission, including misrepresentation, that knowingly or recklessly misleads, or attempts to mislead, a person to obtain a financial or other benefit or to avoid an obligation.

“Governing Authority” has the meaning specified in sub-paragraph (a) of the definition of Host Government.

“Guarantee Currency” means the currency specified in Clause 3 of the Special Conditions.

“Guarantee Holder” means the natural or juridical person so designated in the Special Conditions and who is party to the Contract, which term shall include such person’s successors and permitted assigns that, in either case, meet the requirements of the Convention and the Operational Regulations.

“Guarantee Holder’s Share” means, as applicable:

(a) the percentage of the total number of shares in the Project Enterprise which are directly or indirectly owned by the Guarantee Holder and guaranteed under this Contract, adjusted to reflect any stock splits, stock dividends and other events having similar effects;

(b) the percentage of the total equity ownership interest (other than shares) in the Project Enterprise which is directly or indirectly held by the Guarantee Holder and guaranteed under this Contract, adjusted to reflect any events analogous to stock splits, stock dividends and other events having similar effect;

(c) the ownership by the Guarantee Holder of tangible assets held, directly or indirectly, in the Project Enterprise and guaranteed under this Contract (expressed as a percentage of the total assets of the Project Enterprise);

(d) the percentage interest of the Guarantee Holder in an Award (or, in the case of an Award in favor of the Project Enterprise, the portion of such Award corresponding to the Guaranteed Investment); or

(e) the portion of the Guaranteed Investment determined by MIGA to be due to the Guarantee Holder pursuant to Section 6.5 (or, in the case of a cause of action by the Project Enterprise, the portion of the amount determined to be due to the Project Enterprise pursuant to Section 6.5 corresponding to the Guaranteed Investment).

“Guarantee Period” means the period specified in Clause 6 of the Special Conditions.

“Guaranteed Investment” means the amount and type of investment made or to be made, directly or indirectly, by the Guarantee Holder in the Project Enterprise (which may include
retained earnings) and guaranteed under this Contract to the extent specified in Clause 4B of the Special Conditions.

“Host Country” means the country specified in Clause 2B of the Special Conditions, into which country the Guaranteed Investment is made.

“Host Government” means:

(a) the present or any succeeding governing authority (without regard to the method of its succession or whether it is internationally recognized) in effective control of all or any part of the territory of the Host Country or any political or territorial subdivision thereof (including any dependent territory) (a “Governing Authority”);

(b) any other public or regulatory authority within the territory of the Host Country:

(i) which on the Date of Loss was under the supervision, Control and direction of a Governing Authority; and

(ii) for whose actions a Governing Authority is liable;

(c) with respect to Breach of Contract only, any other public or regulatory authority within the territory of the Host Country which:

(i) is under the supervision, Control and direction of a Governing Authority on the Date of Loss; and

(ii) is otherwise satisfactory to MIGA as of the Effective Date and specifically designated as part of the Host Government in Annex 2; or

(d) with respect to Breach of Contract only, a State-Owned Enterprise.

“Inability to Transfer” means the Covered Risk described as a subset of Transfer Restriction in Subsection 3.1(b).

“Inconvertibility” means the Covered Risk described as a subset of Transfer Restriction in Subsection 3.1(a).

“Indemnity Period” means, with respect to Temporary Loss of Income, the period commencing on the Date of Loss and ending on the earlier of:

(a) the date by which the construction or operation of the Investment Project, as applicable, with due diligence and dispatch and reasonable speed, could have been resumed, at the same level that would have existed if the Loss had not occurred, whether at the same or another location; and

(b) twelve (12) months after the Date of Loss.

“Initial Premium Due Date” means the date specified in Clause 14B of the Special Conditions.

“Interest” means any interest under the Contract owed by or to MIGA, calculated from the date the relevant amount becomes due and payable up to the date payment is received by MIGA or the Guarantee Holder, as the case may be.
“International Financial Reporting Standards” means that set of accounting standards established and issued by the International Accounting Standards Board, as amended from time to time.

“Investment Project” means the project or set of projects to be undertaken by the Project Enterprise and to which the proceeds of the Guaranteed Investment shall be applied, specified in Clause 2A of the Special Conditions.

“LIBOR” means the London Interbank Offered Rate for the Guarantee Currency. For all purposes under the Contract, LIBOR shall be determined on any date (each such date, a “Determination Date”) by reference to:

(a) the rate per annum (rounded upwards, if necessary, to the nearest 1/100 of 1 percent) appearing on Bloomberg Page BBA or, as applicable, BBAM (or any successor page) as the London Interbank Offered Rate for deposits in Guarantee Currency at 11:00 AM (London time) two London business days before such Determination Date for the period commencing on such Determination Date and ending on a date six months after such Determination Date;

(b) in the event of the unavailability of the applicable Bloomberg Page, by the rate per annum (rounded upwards, if necessary to the nearest 1/100 of 1 percent) appearing on the Reuters LIBOR page as the London Interbank Offered Rate for deposits of Guarantee Currency at approximately 11:00 AM (London time) two London business days before such Determination Date for the period commencing on such Determination Date and ending on a date six months after such Determination Date; or

(c) in the event of the unavailability of both the applicable Bloomberg Page and the Reuters Page, six month “LIBOR BBA Interbank Fixing Rate” for the Guarantee Currency as published in the World Interest Rates section of the Financial Times newspaper two London business days before such Determination Date.

“Local Currency” means the national currency of the Host Country.

“Loss” means any loss incurred by the Guarantee Holder that would not have been incurred but for the occurrence of a Covered Risk.

“Loss of Assets” means the Covered Risk described as a subset of War and Civil Disturbance in Subsection 5.1(a).

“Lost Business Income” means:

(a) if the Loss occurs while the Investment Project is operating, the Business Income that would have been earned from the Investment Project if the Loss had not occurred; and

(b) if the Loss occurs prior to the commencement of operations of the Investment Project, the projected Business Income that would have been earned if the delay in operations had not occurred,
but in each case excluding investment income or interest on bank accounts that would
have been earned if the Loss had not occurred.

“Maximum Aggregate Liability” means the maximum aggregate amount of compensation
payable by MIGA under the Contract over the term of the Guarantee Period, irrespective of the
number of Losses, which shall be the amount specified in Clause 10D of the Special Conditions,
as such amount may be reduced in accordance with Article 15.

“Money Laundering” means the acquisition, possession, use, conversion, transfer or
concealment of the true nature of property of any description, and legal documents or instruments
evidencing title to, or interest in, such property, knowing that such property is an economic
advantage from criminal offences, for the purpose of:

(a) concealing or disguising the illicit origin of the property; or

(b) assisting any person who is involved in the commission of the criminal offence as a
result of which such property is generated, to evade the legal consequences of such
actions.

“Net Book Value” means an amount equal to the difference between the value of total tangible
assets (excluding in all cases any goodwill and any deferred foreign exchange gains or losses and
other deferred charges) and the value of total liabilities of the Project Enterprise calculated in
accordance with International Financial Reporting Standards and determined by MIGA from the
audited accounts of the Project Enterprise or, where applicable hereunder, the portion thereof
corresponding to the Guaranteed Investment.

“Notice of Termination” means a notice sent by MIGA or the Guarantee Holder to terminate the
Contract following the procedures specified in Section 16.2, such notice to be effective at
11:59 PM, Washington, DC time, on the relevant date of termination.

“Obstructive Practice” means:

(a) deliberately destroying, falsifying, altering or concealing of evidence material to the
investigation, or making false statements to investigators, in order to materially
impede a World Bank Group investigation into allegations of a corrupt, fraudulent,
coercive or collusive practice, and/or threatening, harassing or intimidating any
person to prevent it from disclosing its knowledge of matters relevant to the
investigation or from pursuing the investigation; or

(b) acts intended to materially impede MIGA’s access to contractually required
information in connection with a World Bank Group investigation into allegations of
a corrupt, fraudulent, coercive or collusive practice.

“Operational Regulations” means the Operational Regulations adopted by MIGA’s Board of
Directors as in force on the Effective Date.

“Percentage of Cover” means such percentage of each Loss for which the Guarantee Holder is
entitled to compensation under the Contract specified in Clause 9A of the Special Conditions.

“Percentage of Self-Insurance” means such percentage of each Loss that the Guarantee Holder
is required to bear for its own account specified in Clause 9B of the Special Conditions.
“Performance Standards and Environmental Guidelines” means with respect to the Investment Project and Project Enterprise:

(a) the Performance Standards listed on Annex 3A;

(b) the General Environmental, Health and Safety Guidelines of the World Bank Group; and

(c) if applicable, the Industry Sector Guidelines specified in Annex 3A.

“Permanent Loss of Use” means the Covered Risk described as a subset of War and Civil Disturbance in Subsection 5.1(c).

“Premium” means:

(a) for the first Contract Period, the amount payable by the Guarantee Holder specified in Clause 11B of the Special Conditions; and

(b) for each subsequent Contract Period, the amount payable by the Guarantee Holder for the coverage provided by the Contract, calculated by taking the product of the following amounts:

(i) the Current Amount of Guarantee as of the first day of such Contract Period;

(ii) the annual premium rate specified in Clause 11A of the Special Conditions; and

(iii) the actual number of days in such Contract Period, calculated using a 365-day year,

and dividing the product so obtained by 365.

“Premium Due Date” means:

(a) for the first Contract Period, the Initial Premium Due Date; and

(b) for each subsequent Contract Period, the first day of such Contract Period.

“Project Agreement” means, with respect to Breach of Contract, one or more of the agreements, contracts or binding commitments in each case either:

(a) between the Guarantee Holder and the Host Government; or

(b) between the Project Enterprise and the Host Government,

and which are in either case directly related to the Investment Project, specified in Annex 2.

“Project Enterprise” means the enterprise specified in Clause 1 of the Special Conditions that is responsible for conducting the Investment Project.

“Provisional Payment” means the amount in Guarantee Currency that MIGA may elect to pay the Guarantee Holder in accordance with Section 6.7 pending the issuance of an Award.
“Reference Rate of Exchange” means with respect to any date the effective rate of exchange on such date for conversion of Local Currency into Guarantee Currency determined as follows:

(a) first, the exchange rate category generally applied on such date for purposes of remittance of earnings with respect to foreign equity investments by the central bank or any other similar regulatory authority charged with the function of establishing the official foreign exchange rate in the Host Country, but, if Guarantee Currency was not generally available at such official exchange rate, then the Reference Rate of Exchange shall be the average effective exchange rate obtained through other legal exchange mechanisms sanctioned by the Host Government applicable to the type of remittance involved;

(b) second, if a rate cannot be determined in accordance with sub-paragraph (a) above, the average clearing rate on such date legally used by the largest three commercial banks (measured by volume of foreign exchange transactions cleared in the most recent 60-day period) in the Host Country; and

(c) third, if a rate cannot be determined in accordance with sub-paragraphs (a) or (b) above, the rate of exchange determined by the International Monetary Fund (IMF) for the Host Country. Any costs of obtaining such rate of exchange through the IMF shall be equally shared by the parties.

The Reference Rate of Exchange shall be calculated taking into account the application of all charges and expenses due in case of conversions and transfers by or on behalf of the Guarantee Holder under the prevailing laws, regulations and business practices of the Host Country.


“Standby Option” means the commitment for additional coverage in connection with phased-in portions of the Guaranteed Investment or the reinvestment of retained earnings, specified in Part IV of the Contract.

“Standby Option Amount” means, for any Contract Period, the initial amount specified in Clause 10C of the Special Conditions, minus the aggregate amount transferred from the Standby Option to the Current Amount of Guarantee in accordance with Section 15.3 of the General Conditions prior to the commencement of such Contract Period.

“Standby Option Fee” means:

(a) for the first Contract Period, the amount payable by the Guarantee Holder specified in Clause 12B of the Special Conditions; and

(b) for each subsequent Contract Period, the amount payable by the Guarantee Holder for the coverage provided in relation to the Standby Option Amount, calculated by taking the product of the following amounts:

(i) the Standby Option Amount as of the first day of such Contract Period;

(ii) the annual Standby Option Fee rate specified in Clause 12A of the Special Conditions; and
(iii) the actual number of days in such Contract Period, calculated using a 365-day year,

and dividing the product so obtained by 365.

“State-Owned Enterprise” means, with respect to Breach of Contract only, an entity (other than a public or regulatory authority):

(a) which on the Date of Loss is under the supervision, Control and direction of a Governing Authority and is performing a public service or fulfilling a governmental function in the Host Country;

(b) for whose obligations a Governing Authority is liable or which is otherwise acceptable to MIGA as of the Effective Date; and

(c) which is specifically designated as part of the Host Government in Annex 2.

“Temporary Loss of Income” means the Covered Risk described as a subset of War and Civil Disturbance in Subsection 5.1(b).

“Total Amount Due” means:

(a) for the first Contract Period, the amount payable by the Guarantee Holder specified in Clause 14A of the Special Conditions, consisting of the sum of the Premium, the Standby Option Fee and the Facility Fee, as applicable; and

(b) for each subsequent Contract Period, the sum of the Premium, the Standby Option Fee and the Facility Fee, as applicable, for such Contract Period.

“Total Equity Investment of the Guarantee Holder” means the total amount of investment made or to be made, directly or indirectly, by the Guarantee Holder in the Project Enterprise, as specified in Clause 4A of the Special Conditions, which amount may be increased over the duration of the Contract as additional investments are made.

“Transfer Restriction” means the Covered Risks described in Section 3.1.

“Waiting Period” means the period of time measured from the Date of Loss, specified in Clause 8 of the Special Conditions for each Covered Risk, which must elapse before MIGA may deem a Claim to be complete.

“War and Civil Disturbance” means the Covered Risks described in Section 5.1.

“World Bank Group” means the International Bank for Reconstruction and Development, the International Development Association, the International Finance Corporation and MIGA.

ARTICLE 3. TRANSFER RESTRICTION

Covered Risks

3.1 The guarantee against Transfer Restriction shall cover a Loss due to any action or inaction by: (i) the Host Government or (ii) entities or persons authorized by the Host
Government under the laws of the Host Country to engage in foreign exchange transactions, in either case which prevents, directly or indirectly, both the Guarantee Holder and the Project Enterprise from legally:

(a) converting into the Guarantee Currency the Local Currency constituting:

(i) dividends, profits, or other monetary benefits derived from the Guaranteed Investment;

(ii) proceeds from the disposal of, or other return of, the Guaranteed Investment; or

(iii) any other return on the Guaranteed Investment;

including the denial of such conversion in an exchange rate category at least as favorable as that used to determine the Reference Rate of Exchange ("Inconvertibility"); or

(b) transferring outside of the Host Country the Guarantee Currency constituting a return of, or a return on, the Guaranteed Investment ("Inability to Transfer"),

provided that the Guarantee Holder or the Project Enterprise, or both, as required:

(x) has for the duration of the applicable Waiting Period continuously applied for and failed to convert the Local Currency or to transfer the Guarantee Currency through the legal exchange mechanisms sanctioned by the Host Government in accordance with the relevant laws, regulations and procedures of the Host Country; and

(y) had on the Effective Date the legal right within the Host Country to convert the Local Currency and transfer the Guarantee Currency.

3.2 A Loss due to the deprivation by the Host Government of the use and control of funds constituting dividends, profits, or other monetary benefits derived from the Guaranteed Investment shall only be covered under Expropriation of Funds pursuant to Subsection 4.1(b).

Compensation

3.3 Subject to Articles 8, 9, and 10, compensation payable under Transfer Restriction shall be the Percentage of Cover of:

(a) for Inconvertibility, the Guarantee Currency equivalent of the Local Currency which could not be converted in respect of the Guaranteed Investment, calculated on the basis of the Reference Rate of Exchange on the Date of Loss; or

(b) for Inability to Transfer, the amount of Guarantee Currency that could not be transferred in respect of the Guaranteed Investment as of the Date of Loss.

Filing of Claims

3.4 The Guarantee Holder may file a Claim for Transfer Restriction at any time from the Date of Loss to the date 180 days after the end of the applicable Waiting Period. The Guarantee Holder shall submit to MIGA promptly all material evidence available to it from time to time as may be necessary to support such Claim for Transfer Restriction, including copies of certifications by the Host Government, or other entities or persons authorized by the Host
Government to conduct foreign exchange transactions, demonstrating the inability of both the Guarantee Holder and the Project Enterprise to convert the Local Currency or transfer the Guarantee Currency, as the case may be, for the duration of the applicable Waiting Period.

3.5 A Claim shall be deemed by MIGA to be complete when MIGA is reasonably satisfied that it has received all of the material evidence required to determine the Guarantee Holder’s right to compensation under the Contract. MIGA shall make a determination with respect to such Claim in accordance with Section 10.1.

Transfer and Assignment

3.6 Prior to or simultaneously with payment of compensation for a Loss, the Guarantee Holder shall or shall cause the Project Enterprise to:

(a) deliver to MIGA in the Host Country in cash (or, at MIGA’s option, by draft subject to collection) the Percentage of Cover of the Local Currency or Guarantee Currency which could not be converted or transferred in respect of the Guaranteed Investment; or

(b) at MIGA’s option, assign and transfer to and for the benefit of MIGA the Percentage of Cover of all the Project Enterprise’s rights in such Local Currency or Guarantee Currency,

provided that any such delivery or assignment to MIGA shall be made free and clear of any claim, defense, counterclaim, right of set off, liens, security interests or other encumbrances.

ARTICLE 4. EXPROPRIATION

Covered Risks

4.1 The guarantee against Expropriation shall cover a Loss due to any legislative action or any executive or administrative action or omission (but excluding any judicial action or omission), in one or a series of events, attributable to the Host Government which, directly or indirectly:

(a) deprives or prevents the Guarantee Holder from exercising its ownership rights in, or effective control of, all or a substantial portion of the Guaranteed Investment; or otherwise deprives the Guarantee Holder or the Project Enterprise of a substantial benefit of the Guaranteed Investment constituting a fundamental right essential to the overall financial viability of the Guaranteed Investment and/or the Project Enterprise ("Expropriation of Investment"); or

(b) deprives the Guarantee Holder or the Project Enterprise, as applicable, of the use and control of any funds constituting dividends, profits, or other monetary benefits derived from the Guaranteed Investment ("Expropriation of Funds");

provided that such Loss continues for the duration of the applicable Waiting Period.

4.2 No measure shall constitute an Expropriation under Section 4.1 if it constitutes a bona fide, non-discriminatory measure of general application that governments normally take for the purpose of regulating economic activity, ensuring public safety, raising revenues or protecting the
4.3 A Loss due to a breach by the Host Government of its obligations under any agreement between or among the Host Government and the Guarantee Holder, the Project Enterprise, or both, where the Host Government is acting in a commercial capacity shall not constitute an Expropriation under Section 4.1.

**Compensation**

4.4 Subject to Articles 8, 9, and 10, compensation payable under Expropriation shall be the Percentage of Cover of:

(a) in the case of Expropriation of Investment, the Guarantee Holder’s Share of:

(i) the Net Book Value of the Project Enterprise (or the portion thereof that has been expropriated); or

(ii) if the Guaranteed Investment constitutes only tangible assets, the Book Value of such tangible assets (or the portion thereof that has been expropriated), in both cases calculated as of the day immediately preceding the Date of Loss; and

(b) in the case of Expropriation of Funds:

(i) the Guarantee Currency equivalent of the Local Currency amount distributable in respect of the Guaranteed Investment, calculated on the basis of the Reference Rate of Exchange prevailing on the Date of Loss; or

(ii) the Guarantee Currency amount distributable in respect of the Guaranteed Investment of which the Guarantee Holder or the Project Enterprise was deprived as of the Date of Loss.

**Filing of Claims**

4.5 The Guarantee Holder may file a Claim for Expropriation at any time from the Date of Loss to the date 180 days after the end of the applicable Waiting Period. The Guarantee Holder shall submit to MIGA promptly all material evidence available to it from time to time as may be necessary to support such Claim for Expropriation, including the audited accounts and financial statements of the Project Enterprise in respect of the Investment Project and other evidence concerning the actions or inactions of the Host Government constituting the Expropriation.

4.6 A Claim shall be deemed by MIGA to be complete when MIGA is reasonably satisfied that it has received all of the material evidence required to determine the Guarantee Holder’s right to compensation under the Contract. MIGA shall make a determination with respect to such Claim in accordance with Section 10.1.

**Transfer and Assignment**

4.7 Prior to or simultaneously with payment of compensation for a Loss, the Guarantee Holder shall in accordance with MIGA’s instructions assign and transfer to and for the benefit of MIGA, free and clear of any claim, defense, counterclaim, right of set off, liens or other encumbrances:
in the case of Expropriation of Investment, the Percentage of Cover of the Guarantee Holder’s Share of the Project Enterprise, or of the tangible assets, as the case may be, (or the portion thereof corresponding to the portion of the Guaranteed Investment that has been expropriated), including all right, title and interest therein; and

(b) in the case of Expropriation of Funds, the Percentage of Cover of the relevant Local Currency or the Guarantee Currency amount, as the case may be.

ARTICLE 5. WAR AND CIVIL DISTURBANCE

Covered Risks

5.1 The guarantee against War and Civil Disturbance shall cover a Loss due to:

(a) the destruction or disappearance of, or physical damage to, tangible assets (other than precious metals, gems, works of art, money or documents) in the Host Country utilized for the Investment Project (“Loss of Assets”);

(b) the temporary suspension or interruption of the construction or operation of all or a portion of the Investment Project for the duration of the applicable Waiting Period due to Loss of Assets or due to unreasonably hazardous conditions that result in the temporary abandonment, evacuation or denial of use of all or a portion of the Investment Project or its facilities (“Temporary Loss of Income”); or

(c) the total inability of the Project Enterprise to conduct operations essential to its overall financial viability as a going concern for the duration of the applicable Waiting Period (“Permanent Loss of Use”),

provided that the Loss is a direct and immediate result of acts of war, revolution, insurrection, civil war, civil commotion, riots or acts of terrorism or sabotage carried out, in each case, by those primarily pursuing political or ideological objectives in the Host Country, including acts against the government of the country of the Guarantee Holder, the nationality of the Guarantee Holder, or any other foreign government or foreign investment.

5.2 For the avoidance of doubt, the issuance by a governmental authority of a travel advisory or similar notice relating to the Host Country is not sufficient to demonstrate unreasonably hazardous conditions in the Host Country for purposes of Temporary Loss of Income.

5.3 A Loss due to acts undertaken merely to further labor, student or other specific interests shall not constitute War and Civil Disturbance under Section 5.1.

Compensation

5.4 Subject to Articles 8, 9, and 10, compensation payable under War and Civil Disturbance shall be, without duplication, the Percentage of Cover of the Guarantee Holder’s Share of:

(a) in the case of Loss of Assets:

(i) the lesser of the replacement cost of such tangible assets with assets of like kind and quality and the reasonable cost of repair of such tangible assets,
provided that such compensation is actually utilized for replacement or repair of such assets, as applicable; or

(ii) if the relevant assets are neither being replaced nor repaired, the Book Value of the affected tangible assets, determined as of the day immediately preceding the Date of Loss;

(b) in the case of Temporary Loss of Income, the sum of the Lost Business Income, Continuing Expenses and Extraordinary Expenses of the Project Enterprise incurred during the Indemnity Period, but not to exceed in the aggregate the sublimit specified in Clause 10B of the Special Conditions; and

(c) in the case of Permanent Loss of Use, the Net Book Value of the Project Enterprise calculated as of the day immediately preceding the Date of Loss.

5.5 MIGA shall deduct from any compensation due for Temporary Loss of Income, the Guarantee Holder’s Share of:

(a) with respect to Extraordinary Expenses, the difference between:

(i) the fair market value, as of the end of the Indemnity Period, of any property that could have been rented or hired at a lesser cost but instead was purchased for temporary use during the Indemnity Period; and

(ii) the rental cost which would have been incurred; and

(b) with respect to Lost Business Income, the Business Income which was not earned by the Project Enterprise but could have been earned by:

(i) using any damaged or undamaged property;

(ii) using any other property available to the Project Enterprise; or

(iii) otherwise replacing the production of the Investment Project by any other means available to the Project Enterprise.

5.6 In the event that MIGA pays compensation for Temporary Loss of Income and subsequently determines that it is liable to pay compensation for Permanent Loss of Use, MIGA shall deduct from such compensation for Permanent Loss of Use that portion of the compensation for Temporary Loss of Income representing Lost Business Income.

Filing of Claims

5.7 The Guarantee Holder may file a Claim for War and Civil Disturbance at any time from the Date of Loss to the date 180 days after the end of the applicable Waiting Period. The Guarantee Holder shall submit to MIGA promptly all material evidence available to it from time to time as may be necessary to support such Claim for War and Civil Disturbance, including:

(a) copies of inventories and audited book entries concerning the assets destroyed, damaged or that have disappeared in the case of Loss of Assets; and
(b) all material evidence related to events preventing the Project Enterprise from operating or carrying out viable business operations in the case of Temporary Loss of Income or Permanent Loss of Use, as applicable.

In the case of Temporary Loss of Income, the Guarantee Holder shall consult with MIGA regarding all Continuing Expenses, and shall receive MIGA’s consent prior to incurring any Extraordinary Expenses.

5.8 Lost Business Income shall be determined based upon the Business Income before the Loss occurred, the likely Business Income if the Loss had not occurred, and any other relevant information including financial records, accounting procedures, bills, invoices, other vouchers, deeds, liens and contracts. MIGA may require an appraisal of the Lost Business Income by an independent appraiser, who shall be selected by MIGA and approved by the Guarantee Holder (such approval not be unreasonably withheld), and whose expenses shall be paid by the Guarantee Holder. The decision of such appraiser shall be final and binding.

5.9 With respect to a Claim for Temporary Loss of Income, the Guarantee Holder may file a Claim at any time after the Waiting Period has elapsed, no more frequently than monthly during the Indemnity Period. For the avoidance of doubt, if construction or operation of the Investment Project resumes at any point during the Indemnity Period, such Indemnity Period shall end, and any future Claims for Lost Business Income shall be subject to a separate Waiting Period, Date of Loss and Indemnity Period. The Guarantee Holder may file successive Claims for Temporary Loss of Income if (x) each Claim meets the requirements of this Article 5 and (y) all such Claims in the aggregate do not exceed the sublimit specified in Clause 10B of the Special Conditions.

5.10 A Claim shall be deemed by MIGA to be complete when MIGA is reasonably satisfied that it has received all of the material evidence required to determine the Guarantee Holder’s right to compensation under the Contract. MIGA shall make a determination with respect to such Claim in accordance with Section 10.1.

Transfer and Assignment

5.11 Prior to or simultaneously with payment of compensation for a Loss, the Guarantee Holder shall, or shall cause the Project Enterprise to, assign and transfer to and for the benefit of MIGA, free and clear of any claim, defense, counterclaim, right of set off, liens or other encumbrances, the Percentage of Cover of the Guarantee Holder’s Share of:

(a) the affected tangible assets with respect to a Claim for Loss of Assets; or

(b) the Project Enterprise with respect to a Claim for Permanent Loss of Use,

including all right, title and interest therein.

ARTICLE 6. BREACH OF CONTRACT

Covered Risks

6.1 The guarantee against Breach of Contract shall cover a Loss that is a direct result of:

(a) the inability of the Guarantee Holder or the Project Enterprise (on behalf of the Guarantee Holder) to enforce an Award rendered in its favor against the Host
Government ("Arbitral Award Default"), provided that the Guarantee Holder and/or the Project Enterprise, as applicable, have made all reasonable efforts to enforce the Award against the Host Government, including initiating and participating in appropriate judicial proceedings, for the duration of the Waiting Period; or

(b) any action by the Host Government (including, for purposes of this subsection only, any agency, ministry, company or other body under the control of the Host Government) that continues for the duration of the Waiting Period and which renders the invocation, operation or formal conclusion of the Dispute Resolution Procedure either:

(i) impossible or unable to proceed as provided by its rules and the terms of the Project Agreement;

(ii) exceptionally hazardous to the physical safety of any representative of the Guarantee Holder or the Project Enterprise, as applicable, or to any other person who is essential to the Dispute Resolution Procedure; or

(iii) in MIGA’s reasonable opinion, commercially impracticable to the Guarantee Holder or the Project Enterprise, as applicable, under the facts and circumstances of the case,

("Denial of Recourse"), provided that:

(x) the Guarantee Holder and/or the Project Enterprise, as applicable, have submitted the dispute to the Dispute Resolution Procedure in accordance with the terms of the Project Agreement and have made all reasonable efforts to cause the Dispute Resolution Procedure to function for the duration of the applicable Waiting Period; and

(y) the Project Agreement or related documentation permits MIGA to join the Dispute Resolution Procedure in the event of payment of compensation hereunder.

6.2 The following shall not constitute Denial of Recourse:

(a) a Loss due to the Host Government’s vigorous defense of a claim which is not otherwise accompanied by unreasonable governmental interference with the Dispute Resolution Procedure;

(b) a Loss due to the Host Government’s failure to submit to or participate in the Dispute Resolution Procedure;

(c) a Loss due to any action or inaction by the Guarantee Holder or the Project Enterprise in connection with the Dispute Resolution Procedure, including failing to take procedural steps within the time limits set by the Dispute Resolution Procedure or consenting to the postponement of a procedural step specified in the Dispute Resolution Procedure; and

(d) a Loss due to failure or refusal of the courts of the Host Country to enforce an Award or contractual remedies in connection therewith.
6.3 No compensation shall be payable for any Loss due to Breach of Contract by:

(a) a State-Owned Enterprise or public authority which, on the Date of Loss, is no longer under the supervision, Control and direction of a Governing Authority, unless the Governing Authority is otherwise legally liable for the obligations of such State-Owned Enterprise or public authority; or

(b) a public or regulatory authority for whose obligations the Governing Authority was liable on the Effective Date, but is no longer liable on the Date of Loss.

Compensation

6.4 Subject to Articles 8, 9, and 10, compensation payable under Arbitral Award Default shall be the Percentage of Cover of the Guarantee Holder’s Share of the Award, less the amount of any Provisional Payments that have been made pursuant to Section 6.7, payable in Guarantee Currency calculated as of the Date of Loss.

6.5 Subject to Section 6.6 and Articles 8, 9, and 10, compensation for Denial of Recourse shall be payable prior to the issuance of an Award and shall be the lesser of:

(a) the Percentage of Cover of the amount determined by MIGA to be due from the Host Government to the Guarantee Holder, or the Percentage of Cover of the Guarantee Holder’s Share of the amount determined by MIGA to be due from the Host Government to the Project Enterprise, as applicable, payable in Guarantee Currency calculated as of the date of such determination; and

(b) the Current Amount of Guarantee.

6.6 If after payment by MIGA of compensation for Denial of Recourse, the Guarantee Holder or the Project Enterprise subsequently receives compensation from the Host Government based on an Award or otherwise, the Guarantee Holder shall repay to MIGA the amount of compensation paid to the Guarantee Holder for Denial of Recourse.

Provisional Payments

6.7 Prior to payment of compensation for Arbitral Award Default, MIGA may, in its sole discretion, make one or more Provisional Payments (normally in an aggregate amount not to exceed 50 percent of the Current Amount of Guarantee), provided that:

(a) the Guarantee Holder and the Project Enterprise, as applicable, have not been able to obtain an Award within a period of 180 consecutive days from initiating the Dispute Resolution Procedure against the Host Government for such breach of a Contractual Obligation in a Project Agreement, or repudiation of such Project Agreement, and the Guarantee Holder has made a written request for Provisional Payments after such time period has elapsed;

(b) MIGA has received an advisory report from an expert following administered expert proceedings as described in Annex 4B; and

(c) if requested by MIGA, the Guarantee Holder has provided MIGA with an irrevocable financial guarantee, in a form and from a guarantor each acceptable to MIGA, to secure repayment of the Provisional Payments as follows:
(i) if the Award is rendered against the Guarantee Holder, the Project Enterprise or both (or against MIGA as subrogee or assignee), the Provisional Payments shall be repaid in full;

(ii) if the Award is rendered in favor of the Guarantee Holder, the Project Enterprise or both (or in favor of MIGA as subrogee or assignee), but the awarded amount is less than the Provisional Payments, the Provisional Payments shall be repaid in the amount of such shortfall; or

(iii) if the Guarantee Holder or the Project Enterprise receives compensation from the Host Government based on the Award, the Provisional Payments shall be repaid to the extent of such compensation received,

in each case, plus Interest at LIBOR plus 1 percent, calculated for the period from the date MIGA makes the respective Provisional Payment until the date the Award is rendered or the date when the Guarantee Holder or the Project Enterprise receives any payment or other recovery from the Host Government, as applicable.

Filing of Claims

6.8 The Guarantee Holder may file a Claim for Breach of Contract at any time from the Date of Loss to the date 180 days after the end of the applicable Waiting Period. The Guarantee Holder shall submit to MIGA promptly all material evidence available to it from time to time as may be necessary to support such Claim for Breach of Contract, including a certified copy of any Award in the case of Arbitral Award Default, or evidence regarding the actions of the Host Government pursuant to which the Guarantee Holder is filing a Claim for Denial of Recourse.

6.9 A Claim shall be deemed by MIGA to be complete when MIGA is reasonably satisfied that it has received all of the material evidence required to determine the Guarantee Holder’s right to compensation under the Contract. Any Claim for Denial of Recourse will not be deemed complete until MIGA has received an advisory report from an expert following administered expert proceedings as described in Annex 4A. MIGA shall make a determination with respect to such Claim in accordance with Section 10.1.

Transfer and Assignment

6.10 Prior to or simultaneously with payment of compensation for a Loss, the Guarantee Holder shall or shall cause the Project Enterprise to assign and transfer to and for the benefit of MIGA, free and clear of any claim, defense, counterclaim, right of set off, liens or other encumbrances, the Percentage of Cover of the Guarantee Holder’s Share of its rights and causes of action against the Host Government in respect of such Loss, including:

(a) in the case of Arbitral Award Default, the Guarantee Holder’s Share of the Award; or

(b) in the case of Denial of Recourse, the Guarantee Holder’s Share of its rights, or the Guarantee Holder’s Share of the Project Enterprise’s rights, as applicable, in the Project Agreement.
ARTICLE 7. PERCENTAGE OF SELF-INSURANCE

7.1 Throughout the Guarantee Period, the Guarantee Holder shall bear for its own account at least the Percentage of Self-Insurance of each potential Loss.

ARTICLE 8. DEDUCTIONS AND ADJUSTMENTS

8.1 MIGA shall deduct from any compensation due hereunder the Guarantee Holder’s Share of any other payment, recovery, or benefit received or due to be received by or for the benefit of the Guarantee Holder, or the Project Enterprise, from any source, including the ratable portion of the Loss payable by any other insurer or guarantor, as a result of the Covered Risks which caused the Loss for which MIGA is liable to pay compensation.

8.2 Amounts of compensation determined to be payable by MIGA for any Loss shall:

(a) in no event exceed:
   
   (i) the Current Amount of Guarantee during the relevant Contract Period;
   
   (ii) the Maximum Aggregate Liability over the term of the Guarantee Period; and
   
   (iii) in the case of Temporary Loss of Income, the sublimit specified in Clause 10B of the Special Conditions;
   
(b) be reduced, before application of any other reduction or adjustment, by any Deductible amount that may be specified under Clause 15 of the Special Conditions; and

(c) be in Guarantee Currency calculated by converting the Local Currency value of all assets and liabilities into Guarantee Currency at the Reference Rate of Exchange prevailing on the day immediately preceding the Date of Loss in cases where the audited financial statements used to calculate the Net Book Value of the Project Enterprise, or the Book Value of the tangible assets, have been prepared in Local Currency.

8.3 If, as of the Date of Loss, any of (i) the Total Equity Investment, (ii) the Net Book Value of the Project Enterprise or (iii) the Book Value of tangible assets guaranteed hereunder, as applicable, exceeds the Guaranteed Investment, then the Guarantee Holder shall be entitled to compensation only for such proportion of any Loss as the Current Amount of Guarantee bears to the greater of (i) the Total Equity Investment, (ii) the Guarantee Holder’s Share of the Net Book Value of the Project Enterprise or (iii) the Guarantee Holder’s Share of the Book Value of such tangible assets, as applicable, in each case calculated as of such Date of Loss.

ARTICLE 9. EXCLUSIONS

9.1 MIGA shall in no case be liable for any Loss which is due to:
(a) the application of any law, decree or regulation in force in the Host Country as of the Effective Date or any action or inaction of the Host Government or any other event occurring prior to the Effective Date;

(b) Corrupt Practices, Fraudulent Practices, Coercive Practices, Collusive Practices, Obstructive Practices, Money Laundering, or violations of any bona fide non-discriminatory laws or regulations of general application not designed by the Host Government to have a confiscatory effect, in each case attributable to the Guarantee Holder or the Project Enterprise in connection with the Investment Project;

(c) the non-compliance by the Guarantee Holder or the Project Enterprise with the Performance Standards and Environmental Guidelines that were in effect on the Effective Date in connection with the Investment Project;

d) the failure of the Project Enterprise or the Guarantee Holder to ensure that all documentation relating to the Investment Project has been duly authorized and executed and that the obligations contained therein are legal, valid, binding, and enforceable in accordance with their terms;

e) the breach by the Project Enterprise or the Guarantee Holder in any material respect of its obligations to the Host Government in connection with the Investment Project; or

(f) any action or inaction of the Host Government that was agreed to by the Guarantee Holder or the Project Enterprise in connection with the Investment Project.

ARTICLE 10. CLAIMS DETERMINATION AND PAYMENT

10.1 A Claim shall demonstrate to MIGA’s reasonable satisfaction the Guarantee Holder’s right to compensation under the Contract. MIGA shall determine its liability to pay compensation for a Loss, and shall notify the Guarantee Holder of such determination, no later than 30 days from the later of:

(a) the end of the applicable Waiting Period for each Covered Risk; and

(b) the date that MIGA deems the Guarantee Holder’s Claim to be complete.

MIGA may deem the Guarantee Holder to have withdrawn a Claim if, within 90 days after a request by MIGA for additional information or evidence with respect to such Claim, the Guarantee Holder fails to supply, or to make reasonable efforts to supply, such information or evidence.

10.2 MIGA shall pay compensation for a Loss within 30 days from the date it determines that it is liable to pay a Claim.

10.3 MIGA shall pay Interest at LIBOR on any amount of compensation determined to be due but not paid at the end of such 30 day period, such liability being in lieu of any other liability as a result of such late payment.
10.4 MIGA shall have no liability for any Claim filed by the Guarantee Holder after 180 days from the end of the applicable Waiting Period for each Covered Risk.

10.5 MIGA shall have no liability for any Loss occurring after the expiration of the Guarantee Period. Notwithstanding the foregoing, with respect to Arbitral Award Default and Denial of Recourse, MIGA may be liable to pay compensation for a Loss if the Dispute Resolution Procedure is initiated before the end of the Guarantee Period but the Award is rendered or the event giving rise to Denial of Recourse occurs after the Guarantee Period and, in each case, a Claim is filed in writing with MIGA within a period of 18 months from the last day of the Guarantee Period.

ARTICLE 11. SUBROGATION

11.1 Upon payment of compensation by MIGA, MIGA shall be fully subrogated, up to the amount of such compensation, to all claims, causes of action, recoveries and other rights the Guarantee Holder has against the Host Government, the Project Enterprise or any obligor in respect of the Covered Risk causing the Loss, and the Guarantee Holder shall take no action whatsoever to prejudice MIGA’s rights of subrogation.

11.2 Nothing in the Contract shall in any way be deemed to be a waiver of, or otherwise affect, any independent right of MIGA to effect salvage or other recoveries under the Contract (without any obligation to share the proceeds thereof) through agreements between MIGA and the Host Government or any obligor.

11.3 If MIGA pays compensation for a Loss and the Guarantee Holder subsequently receives compensation for all or a portion of the Guaranteed Investment from the Project Enterprise, the Host Government, or any other source, the Percentage of Cover of the Guaranteed Investment or portion thereof received shall be held in trust (as property of MIGA) for the benefit of MIGA, and the Guarantee Holder shall promptly upon receipt thereof pay over such amount to MIGA.

ARTICLE 12. REPRESENTATIONS, WARRANTIES, AND DUTIES OF GUARANTEE HOLDER

12.1 During the Guarantee Period, and during any period after the Guarantee Period in which the Guarantee Holder has a pending Claim, the Guarantee Holder shall, and shall cause the Project Enterprise to:

(a) maintain and preserve:

(i) audited accounts of the Project Enterprise in accordance with International Financial Reporting Standards;

(ii) any other material information relating to the Guaranteed Investment and the Investment Project; and

(iii) all required registrations, filings, declarations, authorizations, approvals, permits, consents, concessions and licenses required for the establishment of the Project Enterprise and the operation of the Investment Project in the Host Country.
(b) promptly furnish MIGA with such accounts and information as MIGA may reasonably request from time to time and permit MIGA’s duly authorized representatives to examine and make copies of audits, accounts, books, financial statements and any other material information relating to the Investment Project whenever required or wherever located;

(c) submit all material evidence reasonably available to it as MIGA may reasonably request from time to time to evaluate and process a Claim within 30 days of such request;

(d) comply with and abide by all laws and regulations of the Host Country in implementing the Investment Project, including environmental laws and regulations and those that protect core labor standards and comply with its obligations to the Host Country in connection with the Investment Project;

(e) operate the Investment Project in compliance with the requirements of the Performance Standards and Environmental Guidelines;


(g) immediately notify MIGA in writing upon learning of any event or circumstance that could cause, or materially increase the likelihood of, a Loss, including, without limitation, any outstanding or incipient disputes between itself or the Project Enterprise and the Host Government, or any pending or threatened action or administrative proceeding by or before any court, arbitral tribunal, or agency which might have a material adverse effect on the Project Enterprise or the Investment Project;

(h) notify MIGA in writing upon making any additional investments in the Project Enterprise (including phased-in investment and the reinvestment of retained earnings);

(i) use all reasonable efforts to preserve and protect the Investment Project (including, in the case of Temporary Loss of Income, taking all reasonable actions so that the construction or operation of the Investment Project may be resumed as quickly as possible without undue expense) and take all measures, including such administrative, judicial, arbitral or other available remedies, to avert or, if a Covered Risk giving rise to a Loss occurs, minimize a potential Loss;

(j) permit MIGA, or any authorized representative of MIGA, to examine the Investment Project;

(k) waive no right, claim, cause of action or other remedy or accept any offer of compensation in respect of any Loss;

(l) at MIGA’s reasonable expense, cooperate fully with MIGA in the administration, preservation and protection of assets acquired by MIGA, and in the prosecution of any rights, claims, causes of action and other interests obtained by MIGA pursuant to Article 11;
(m) allow MIGA to conduct environmental and developmental monitoring of the Investment Project and the Project Enterprise, at MIGA’s request; and

(n) within 30 days after the third anniversary of the Effective Date, provide MIGA with the Development Effectiveness Indicators set forth in Annex 3B.

12.2 The Guarantee Holder shall, throughout the Guarantee Period, remain eligible to receive coverage from MIGA in accordance with the Convention.

12.3 The Guarantee Holder shall not without the prior written consent of MIGA:

(a) assign, transfer, or encumber any rights under the Contract; or

(b) amend, modify, supplement or waive any material rights or obligations with respect to the Project Agreements or an Award, or transfer or assign any rights under the Project Agreements or an Award.

12.4 The Guarantee Holder hereby represents and warrants, as of the Effective Date, and shall be deemed to represent and warrant during the Guarantee Period and at any time thereafter during which a Claim is pending, that:

(a) all information, representations, and warranties made in the Application for Guarantee, as well as any written information provided by or on behalf of the Guarantee Holder to MIGA from time to time, including in connection with any Claim, are true and correct in all material respects and do not contain any materially false or misleading statements or omissions;

(b) the Guarantee Holder and the Project Enterprise have obtained in full force and effect all required registrations, filings, declarations, authorizations, approvals, permits, consents, concessions and licenses required for the establishment of the Project Enterprise and the operation of the Investment Project in the Host Country;

(c) all documentation relating to the Investment Project has been duly authorized and executed and the obligations contained therein are legal, valid, binding, and enforceable in accordance with their terms;

(d) except as disclosed to MIGA pursuant to Section 12.1(g), there are no outstanding or incipient disputes between itself or the Project Enterprise and the Host Government; and no action or administrative proceeding by or before any court, arbitral tribunal, or agency which might have a material adverse effect on the Project Enterprise or the Investment Project is pending or, to the best of the Guarantee Holder’s knowledge, threatened;

(e) the Project Enterprise has not engaged in any Corrupt Practices, Fraudulent Practices, Coercive Practices, Collusive Practices, Obstructive Practices, or Money Laundering in connection with the Investment Project; and

(f) the Project Enterprise is in compliance with the Performance Standards and Environmental Guidelines in connection with the Investment Project.
12.5 In connection with and subsequent to payment of compensation by MIGA under this Contract, the Guarantee Holder shall, and shall use all reasonable efforts to cause the Project Enterprise to, when requested by and in consultation with MIGA, take all commercially reasonable measures to:

(a) pursue available administrative and judicial remedies arising from the Loss, in cooperation with or on behalf of MIGA, against the Host Government;

(b) negotiate in good faith with the Host Government, in cooperation with or on behalf of MIGA; and

(c) pursue other potential sources of recovery for the Loss.

ARTICLE 13. CONDITIONS FOR TERMINATION

13.1 Except as provided for under Sections 10.5, 13.2, 13.3, 13.4, 13.5, and 13.6, the Contract shall terminate at 11:59 PM, Washington, DC time, on the last day of the Guarantee Period.

Termination by Guarantee Holder

13.2 The Guarantee Holder may terminate the Contract on any anniversary of the Effective Date by submitting to MIGA a Notice of Termination at least 30 days prior to such anniversary of the Effective Date.

Termination by MIGA

13.3 If the Guarantee Holder fails to pay the full amount of the Total Amount Due on the Initial Premium Due Date, MIGA may by notice to the Guarantee Holder terminate the Contract immediately, retroactively to the Effective Date and without any obligation whatsoever, rendering the Contract null and void and, irrespective of whether a Notice of Termination has been delivered, MIGA shall have no liability to pay compensation for any Loss arising during any period between the Effective Date and the Initial Premium Due Date. With respect to each subsequent Contract Period, if the Guarantee Holder fails to pay the full amount of the Total Amount Due (including any Interest thereon) on the applicable Premium Due Date, and such failure continues for a period of 30 days after written notice to the Guarantee Holder of such nonpayment, MIGA may by Notice of Termination terminate the Contract as of 12:01 AM Washington, DC time retroactively to the first day of the Contract Period for which the Total Amount Due has not been paid. Irrespective of whether a Notice of Termination has been delivered, MIGA shall have no liability to pay compensation for any Loss arising during any period in which any portion of the Total Amount Due then due and payable was unpaid.

13.4 MIGA may terminate this Contract, without any further obligation hereunder, effective on the date of MIGA’s Notice of Termination, if at any time MIGA reasonably determines that:

(a) any representation or warranty made by the Guarantee Holder in this Contract, the Application for Guarantee or in other written information provided in connection with this Contract, including any information material to a Covered Risk, proves to be untrue in any material respect or the Guarantee Holder intentionally omits such material information;
(b) the Guarantee Holder fails to comply with the confidentiality provisions of Section 16.3;

(c) the Guarantee Holder is in non-compliance with any other responsibility or obligation specified under the Contract except:

   (i) a default for non-payment of any portion of the Total Amount Due under Section 13.5, for which the remedy set forth in Section 13.5 shall apply; and

   (ii) non-compliance with the obligation set forth in Section 12.1(n);

(d) the Guarantee Holder or the Project Enterprise, as applicable, is in material violation of the laws and regulations of the Host Country with respect to the Guaranteed Investment or the Investment Project;

(e) the Guarantee Holder or the Project Enterprise, as applicable, is in material violation of the Performance Standards and Environmental Guidelines in connection with the Investment Project;

(f) the Guarantee Holder or the Project Enterprise, as applicable, is engaging in Money Laundering in connection with the Investment Project; or

(g) the Guarantee Holder or the Project Enterprise, as applicable, is engaging in Corrupt Practices, Fraudulent Practices, Coercive Practices, Collusive Practices or Obstructive Practices in connection with the Investment Project,

provided, however, that MIGA may grant, at its sole discretion, a reasonable period of time to cure the situations listed in Subsections (d) through (g) above.

**Early Termination Fee; Amounts Previously Paid**

13.5 If there is any termination of the Contract during the first three years of the Guarantee Period, the Guarantee Holder shall pay to MIGA 50 percent of the total Premium and Standby Option Fee, based on the Current Amount of Guarantee and Standby Option Amount, that the Guarantee Holder would otherwise have paid during the remaining Contract Periods falling within the first three years of the Contract, had it not been for such termination. This payment shall not apply in cases of:

   (a) liquidation, bankruptcy, insolvency, winding up, dissolution, or similar measure relating to the Project Enterprise; or

   (b) the sale or assignment of the Guaranteed Investment to an unrelated third party.

13.6 MIGA shall not be liable to return to the Guarantee Holder any portion of the Total Amount Due previously paid to MIGA if the Contract is terminated at any time over the term of the Guarantee Period.
ARTICLE 14. DISPUTE RESOLUTION AND APPLICABLE LAW

14.1 Any dispute between the Guarantee Holder and MIGA arising out of or in connection with the Contract shall be settled by final and binding arbitration in accordance with the Rules of Arbitration.

14.2 The arbitral tribunal constituted under the Rules of Arbitration shall apply the Contract, the Convention and, to the extent that issues in dispute are not covered by the Contract or the Convention, the arbitral tribunal shall apply general principles of law. The seat of arbitration shall be The Hague, Netherlands and the language of the arbitration shall be English.

14.3 The award of the arbitral tribunal shall be final and binding and shall be carried out without delay.

ARTICLE 15. COVERAGE ADJUSTMENTS AND PREMIUM PAYMENTS

15.1 The Current Amount of Guarantee and the Maximum Aggregate Liability shall be reduced for the remainder of the Guarantee Period by the amount of compensation paid by MIGA pursuant to any Claim.

15.2 If the Guarantee Holder’s Share of the Net Book Value of the Project Enterprise or the Book Value of the tangible assets guaranteed hereunder (as applicable) has decreased, both the Current Amount of Guarantee and the Maximum Aggregate Liability may also be reduced for the remainder of the Guarantee Period by the amount of any corresponding reduction irrevocably elected by the Guarantee Holder by delivery to MIGA not less than 30 days before the first day of any Contract Period of a notice in the form of Annex 5A; provided, however, that for any given Contract Period, such election may not reduce the Current Amount of Guarantee for such Contract Period or the Maximum Aggregate Liability to below the Percentage of Cover of the Guarantee Holder’s Share of the Net Book Value of the Project Enterprise or the Book Value of the tangible assets guaranteed hereunder (as applicable), in each case as of the first day of such Contract Period.

15.3 Where the Guaranteed Investment is made over a period of time (including phased-in investment and the reinvestment of retained earnings), so long as no Covered Risk giving rise to a Loss has occurred, the Guarantee Holder may, by delivery to MIGA not less than 30 days before the first day of any Contract Period of a notice in the form of Annex 5B, irrevocably elect to increase the Current Amount of Guarantee for such Contract Period and each successive Contract Period during the Guarantee Period by transferring amounts from the Standby Option Amount to the Current Amount of Guarantee. At any time after a Covered Risk giving rise to a Loss has occurred, the Standby Option shall be immediately suspended until reinstated at MIGA’s sole discretion.

15.4 The Guarantee Holder shall pay to MIGA:

(a) the Total Amount Due on each Premium Due Date; and

(b) with respect to any amount thereof not paid on the Premium Due Date, such amount plus Interest thereon at LIBOR plus 3 percent.
ARTICLE 16. MISCELLANEOUS

Survival

16.1 The rights and obligations contained in Articles 10, 11, and 14, and Sections 12.1, 12.5, and 16.3 shall survive the termination of this Contract.

Notices

16.2 Every notice, request, application, consent, approval, or waiver, including the Notice of Termination, concerning the Contract shall be in writing and shall be made when it is delivered by hand, courier, certified mail, or facsimile when transmission has been completed, to the address for such party specified in Clause 17 of the Special Conditions.

Confidentiality

16.3 (a) The Guarantee Holder shall not, without MIGA’s prior written consent, at any time disclose any terms or conditions of the Contract, or any information made available by MIGA to the Guarantee Holder with respect thereto and designated as confidential to any third party other than government regulators in the country of the Guarantee Holder and the Guarantee Holder’s lawyers, auditors, accountants, financial advisors, syndicate and prospective lenders and rating agencies.

(b) Disclosure of the Contract to government regulators of the Host Country, unless required by enforcement of a law or regulation, will require MIGA’s prior written consent, such consent not to be unreasonably withheld.

(c) Subject to Subsection (d) of this Section 16.3, MIGA shall take all practicable measures to comply with any reasonable request of the Guarantee Holder to safeguard the confidentiality of all documents, data and other information received by MIGA and clearly labeled on the face as “Confidential”. Notwithstanding the foregoing, in accordance with the policies specified in the Operational Regulations, MIGA may disclose certain information, including:

(i) summary information relating to the Investment Project, including data relating to the developmental impact of the Investment Project, the name and country of the Guarantee Holder, the Host Country, the Guaranteed Investment, the Maximum Aggregate Liability and the Covered Risks; and

(ii) any environmental impact assessment reports provided to MIGA with respect to the Guaranteed Investment or the Investment Project.

(d) Subsection (c) of this Section 16.3 shall not apply to:

(i) information that is or becomes matter of public knowledge or is obtained by MIGA from any source other than the Guarantee Holder or any of the Guarantee Holder’s respective agents or representatives, including employees, attorneys, and financial advisors; and

(ii) information disclosed to directors, officers, employees, accountants, consultants, and counsel of MIGA, or of other members of the World Bank Group, and reinsurers, insurers under MIGA’s Cooperative Underwriting Program and brokers, agents, and finders representing MIGA in connection...
with the Investment Project, who may require such material for the purpose of evaluating the Investment Project.

(e) In the event that MIGA is requested or required in the context of administrative or judicial proceedings to disclose any confidential information, MIGA will provide the Guarantee Holder with prompt notice of such request(s) so that the Guarantee Holder may seek an appropriate protective order or other appropriate remedy or waive MIGA’s obligation to comply with the provisions of this Section 16.3. In the event that such protective order or other remedy is not obtained, MIGA will furnish that portion of the confidential information which, in the opinion of MIGA, it is legally compelled to disclose.

Amendments and Waivers

16.4 No provision of the Contract may be amended, modified, supplemented, or waived except in a written agreement executed by authorized representatives of the Guarantee Holder and MIGA.

16.5 Without prejudice to Article 34 of the Rules of Arbitration, neither MIGA nor the Guarantee Holder shall be deemed to have waived any of its rights under the Contract unless expressly so stated in a notice by the party waiving such right to the other party.
Part III – Amendments

[NOT APPLICABLE TO THIS CONTRACT.]

[The following additional provisions and amendments to the General Conditions of Guarantee for Equity Investments (Part II of the Contract) are hereby incorporated as Part III of the Contract:]
ARTICLE 1.

1.1 This Standby Option (Commitment for Additional Coverage) for phased-in portions of the Guaranteed Investment and the reinvestment of retained earnings (“Standby Option”) is incorporated into the Contract as Part IV.

1.2 In accordance with Section 15.3 of the General Conditions, upon a written request by the Guarantee Holder and in accordance with the conditions hereinafter specified, MIGA hereby agrees that the Guarantee Holder may increase the Current Amount of Guarantee under the Contract using the Standby Option Amount elected by the Guarantee Holder hereunder.

ARTICLE 2.

2.1 In accordance with Section 15.3 of the General Conditions, the Current Amount of Guarantee under the Contract may be increased during the Guarantee Period by a maximum amount of [Amount in Guarantee Currency].
Annex 1 – MIGA’s Anti-Corruption Guidelines
(as in effect on October 15, 2006)

The purpose of these Guidelines is to clarify the meaning of the terms “Corrupt Practices”, “Fraudulent Practices”, “Coercive Practices”, “Collusive Practices” and “Obstructive Practices” in the context of MIGA operations.

CORRUPT PRACTICES

A “Corrupt Practice” is the offering, giving, receiving or soliciting, directly or indirectly, of anything of value to influence improperly the actions of another person.

Interpretation

1. Corrupt Practices are understood as kickbacks and bribery. The conduct in question must involve the use of improper means (such as bribery) to violate or derogate a duty owed by the recipient in order for the payor to obtain an undue advantage or to avoid an obligation. Antitrust, securities and other violations of law that are not of this nature are excluded from the definition of Corrupt Practices.

2. It is acknowledged that foreign investment agreements, concessions and other types of contracts commonly require investors to make contributions for bona fide social development purposes or to provide funding for infrastructure unrelated to the project. Similarly, investors are often required or expected to make contributions to bona fide local charities. These practices are not viewed as Corrupt Practices for purposes of these definitions, so long as they are permitted under local law and fully disclosed in the payor’s books and records. Similarly, an investor will not be held liable for Corrupt or Fraudulent Practices committed by entities that administer bona fide social development funds or charitable contributions.

3. In the context of conduct between private parties, the offering, giving, receiving or soliciting of corporate hospitality and gifts that are customary by internationally accepted industry standards shall not constitute Corrupt Practices unless the action violates applicable law.

4. Payment by private sector persons of the reasonable travel and entertainment expenses of public officials that are consistent with existing practice under relevant law and international conventions will not be viewed as Corrupt Practices.

5. The World Bank Group does not condone facilitation payments. For the purposes of implementation, the interpretation of “Corrupt Practices” relating to facilitation payments will take into account relevant law and international conventions pertaining to corruption.
FRAUDULENT PRACTICES

A “Fraudulent Practice” is any action or omission, including misrepresentation, that knowingly or recklessly misleads, or attempts to mislead, a person to obtain a financial benefit or to avoid an obligation.

Interpretation

1. An action, omission, or misrepresentation will be regarded as made recklessly if it is made with reckless indifference as to whether it is true or false. Mere inaccuracy in such information, committed through simple negligence, is not enough to constitute a “Fraudulent Practice” for purposes of World Bank Group sanctions.

2. Fraudulent Practices are intended to cover actions or omissions that are directed to or against a World Bank Group entity. It also covers Fraudulent Practices directed to or against a World Bank Group member country in connection with the award or implementation of a government contract or concession in a project financed by the World Bank Group. Frauds on other third parties are not condoned but are not specifically sanctioned in IFC, MIGA, or PRG operations. Similarly, other illegal behavior is not condoned, but will not be sanctioned as a Fraudulent Practice under the World Bank sanctions program as applicable to IFC, MIGA and PRG operations.

COERCIVE PRACTICES

A “Coercive Practice” is impairing or harming, or threatening to impair or harm, directly or indirectly, any person or the property of a person to influence improperly the actions of a person.

Interpretation

1. Coercive Practices are actions undertaken for the purpose of bid rigging or in connection with public procurement or government contracting or in furtherance of a Corrupt Practice or a Fraudulent Practice.

2. Coercive Practices are threatened or actual illegal actions such as personal injury or abduction, damage to property, or injury to legally recognizable interests, in order to obtain an undue advantage or to avoid an obligation. It is not intended to cover hard bargaining, the exercise of legal or contractual remedies or litigation.

COLLUSIVE PRACTICES

A “Collusive Practice” is an arrangement between two or more persons designed to achieve an improper purpose, including to influence improperly the actions of another person.

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1 “IFC” means the International Finance Corporation, a member of the World Bank Group.

2 “PRG” means the Partial Risk Guarantee operations conducted by the Project Finance Group of the International Bank for Reconstruction and Development.
Interpretation

Collusive Practices are actions undertaken for the purpose of bid rigging or in connection with public procurement or government contracting or in furtherance of a Corrupt Practice or a Fraudulent Practice.

**OBSTRUCTIVE PRACTICES**

An “Obstructive Practice” is: (a) deliberately destroying, falsifying, altering or concealing of evidence material to the investigation or making of false statements to investigators, in order to materially impede a World Bank Group investigation into allegations of a corrupt, fraudulent, coercive, or collusive practice, and/or threatening, harassing or intimidating any person to prevent it from disclosing its knowledge of matters relevant to the investigation or from pursuing the investigation; or (b) acts intended to materially impede MIGA’s access to contractually required information in connection with a World Bank Group investigation into allegations of a corrupt, fraudulent, coercive or collusive practice.

Interpretation

Any action legally or otherwise properly taken by a person to maintain or preserve its regulatory, legal or constitutional rights such as the attorney-client privilege, regardless of whether such action had the effect of impeding an investigation, does not constitute an Obstructive Practice.

General Interpretation

A person should not be liable for actions taken by unrelated third parties unless the first person participated in the prohibited act in question.
Annex 2 – Project Agreements and Contractual Obligations

[NOT APPLICABLE TO THIS CONTRACT.]
Annex 3A – Performance Standards and Environmental Guidelines

Performance Standard 1: Social and Environmental Assessment and Management System
Performance Standard 2: Labor and Working Conditions
Performance Standard 3: Pollution Prevention and Abatement
Performance Standard 4: Community Health, Safety and Security
Performance Standard 5: Land Acquisition and Involuntary Resettlement
Performance Standard 6: Biodiversity Conservation and Sustainable Natural Resource Management
Performance Standard 7: Indigenous Peoples
Performance Standard 8: Cultural Heritage

Please select one of the following:

For Banking Contracts:
The General Environmental, Health and Safety Guidelines and Industry Sector Guidelines may apply.

For All Other Contracts:
The General Environmental, Health and Safety Guidelines and Industry Sector Guidelines for [insert applicable industry], but also including any other sector guideline that may apply.

MIGA’s Performance Standards on Social and Environmental Sustainability and Environmental Guidelines may be found at:
Annex 3B – Development Effectiveness Indicators

This Annex serves as a means for updating data estimates that were previously provided by the Guarantee Holder to MIGA during the underwriting process. MIGA requires that the development effectiveness indicators listed below be submitted on the third anniversary of the Effective Date in order to monitor and track the Project Enterprise’s development outcomes in the years following the implementation of the Investment Project.

The Guarantee Holder or Project Enterprise is to complete Section One and Section Two below. Indicator definitions are included for reference purposes. All financial values should be denominated in Guarantee Currency.

Where the requested information depends on annual reports, the Project Enterprise may use data obtained during its fiscal year (rather than the anniversary of the Effective Date), providing partial data for Year 1 and full data for Years 2 and 3.

Section One: General Indicators

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<th>Indicator</th>
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<td>Investment Mobilized</td>
<td>Guarantee Currency</td>
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<td>Locally Procured Goods</td>
<td>Guarantee Currency</td>
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<td>Training Outlays</td>
<td>Guarantee Currency</td>
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<tr>
<td>Community Development Outlays</td>
<td>Guarantee Currency</td>
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Definitions

Investment Mobilized

The planned amount of equity and debt financing (both foreign and local) invested in the Project Enterprise.

For greenfield investments, Investment Mobilized is represented by the total amount of equity and debt (with a maturity exceeding one year) contributed to the Project Enterprise in each year.

For expansion projects, Investment Mobilized refers to the incremental amount of equity and debt (with a maturity exceeding one year) contributed to the Project Enterprise in each year.
For financial sector projects, Investment Mobilized refers to the amount of equity and debt (with a maturity exceeding one year) contributed to the Project Enterprise in each year, including but not limited to equity investments, time deposits, bonds, commercial borrowing, and shareholder loans.

**Taxes and Fees**

All transfers to all levels of the Host Government made by the Project Enterprise, its parent company, or its operating subsidiary on behalf the Project Enterprise, including: income or profit taxes, sales, and excise taxes, and VAT receipts. Other payments collected by the Host Government include royalties, bonuses, dividends, management/concession fees, value of profit oil and product-sharing, construction activities, licensing, permitting, etc. Amounts should be reported on an annual basis.

**Locally Procured Goods and Services**

The Project Enterprise’s annual purchase of goods and services from local suppliers (including raw materials, civil works, engineering and installation, security, gardening and marketing and research from local companies), but excluding utility bills and government-provided services.

**Training Outlays**

The Project Enterprise’s yearly expenditures on training activities carried out for the Project Enterprise that directly benefits its employees. This may include funding from the Project Enterprise directly, its parent company, or a third party.

**Direct Employment (#)**

Total number of employees working directly for the Project Enterprise. Subcontractor employment should not be reported.

**Permanent Employment**

Total number of direct employees of the Project Enterprise who have contracts exceeding one year in length.

**Temporary Employment**

Total number of direct employees of the Project Enterprise who have contracts equal to or less than one year in length.

**Community Development Outlays**

Expenditures made by the Project Enterprise, its parent company, or its operating subsidiaries either in whole or in part to help local communities.
Section Two: Sector-Specific Indicators
[To be provided for each Investment Project]
Annex 4A – Expert Advisory Report
Supporting a Claim for Denial of Recourse

[NOT APPLICABLE TO THIS CONTRACT.]

1. In connection with any Claim for Denial of Recourse pursuant to Section 6.1(b) of the General Conditions, the Guarantee Holder and MIGA shall submit the matter to administered expertise proceedings in accordance with the Rules for Expertise of the International Chamber of Commerce (“ICC”) in force at the time of such request.

2. The only issues to be reviewed by the expert appointed by the ICC will be the allegations forming the basis of the Dispute Resolution Procedure between the Guarantee Holder or the Project Enterprise and the Host Government. The expert will issue an advisory report on the merits of the Guarantee Holder’s or Project Enterprise’s allegations against the Host Government and the likelihood of success in any Dispute Resolution Procedure. Such report shall also include a valuation of any award against the Host Government should one be rendered in favor of the Guarantee Holder or Project Enterprise, as applicable. The findings of the expert shall be rendered solely for the purpose of assisting MIGA in its determination of the Claim for Denial of Recourse. The expert’s advisory report shall not be binding on MIGA and shall be of an advisory nature only.

3. All fees and expenses incurred in connection with the administered expertise proceedings shall be borne and paid by the Guarantee Holder.

4. Any documents prepared or produced in connection with the administered expertise proceedings, the statement of the expert’s mission and the expert’s report and findings shall be confidential in accordance with Section 16.3 of the General Conditions. In no case will such materials be used or produced by either the Guarantee Holder or MIGA in any proceeding with any third party unless such use or production is duly compelled in connection with such proceeding.
Annex 4B – Expert Advisory Report Regarding Provisional Payments

[NOT APPLICABLE TO THIS CONTRACT.]

1. In connection with a request for a Provisional Payment pursuant to Section 6.7 of the General Conditions, the Guarantee Holder and MIGA shall submit the matter to administered expertise proceedings in accordance with the Rules for Expertise of the International Chamber of Commerce (“ICC”) in force at the time of such request.

2. The only issues to be reviewed by the expert appointed by the ICC will be the allegations forming the basis of the Dispute Resolution Procedure between the Guarantee Holder or the Project Enterprise and the Host Government. The expert will issue an advisory report on the merits of the Guarantee Holder’s or Project Enterprise’s allegations against the Host Government and the likelihood of success in any Dispute Resolution Procedure. Such report shall also include a valuation of any award against the Host Government should one be rendered in favor of the Guarantee Holder or Project Enterprise, as applicable. The findings of the expert shall be rendered solely for the purpose of assisting MIGA in its decision on making a provisional payment. The expert’s advisory report shall not be binding on MIGA and shall be of an advisory nature only.

3. All fees and expenses incurred in connection with the administered expertise proceedings shall be borne and paid by the Guarantee Holder.

4. Any documents prepared or produced in connection with the administered expertise proceedings, the statement of the expert’s mission and the expert’s report and findings shall be confidential in accordance with Section 16.3 of the General Conditions. In no case will such materials be used or produced by either the Guarantee Holder or MIGA in any proceeding with any third party unless such use or production is duly compelled in connection with such proceeding.
Annex 5A – Form of Notice of Reduction in Current Amount of Guarantee and Maximum Aggregate Liability

Must be dated and received by MIGA not less than 30 days before the first day of applicable Contract Period.

[Date]

By Facsimile: +1 202-522-2630

Multilateral Investment Guarantee Agency
1818 H Street, NW
Washington, DC 20433
United States of America

Attn: Contract Management & Portfolio Services
MIGA Operations

Ladies and Gentlemen:


All capitalized terms used herein and not otherwise defined shall have their respective meanings specified in the Contract of Guarantee.

The Guarantee Holder hereby certifies as follows:

1. The Maximum Aggregate Liability as of the date hereof is [Amount in Guarantee Currency]. The Current Amount of Guarantee as of the date hereof is [Amount in Guarantee Currency].

2. The first day of the upcoming Contract Period is [_______], 20[__], on which date the Guarantee Holder’s Share of [the Net Book Value of the Project Enterprise] [the Book Value of tangible assets guaranteed] will be [Amount in Guarantee Currency].

3. In accordance with Section 15.2 of the General Conditions, the Guarantee Holder irrevocably elects to reduce the Current Amount of Guarantee and the Maximum Aggregate Liability as of the first day of the upcoming Contract Period, for such Contract Period and the remainder of the Guarantee Period, so that as of such first day of the upcoming Contract Period: (a) the Current Amount of Guarantee shall be [Amount in Guarantee Currency];
(b) the remaining Standby Option Amount shall be [Amount in Guarantee Currency]; and
(c) the Maximum Aggregate Liability shall be [Amount in Guarantee Currency, sum of (a) and (b)].

Sincerely,

[GUARANTEE HOLDER]

By: __________________________
   (signature)

______________________________
Authorized Representative
   (name and title)

______________________________
   (place and date)
Annex 5B – Form of Notice of Increase in Current Amount of Guarantee

[NOT APPLICABLE TO THIS CONTRACT.]

Must be dated and received by MIGA not less than 30 days before the first day of applicable Contract Period

[Date]

By Facsimile: +1 202-522-2630

Multilateral Investment Guarantee Agency
1818 H Street, NW
Washington, DC 20433
United States of America

Attn: Contract Management & Portfolio Services
MIGA Operations

Ladies and Gentlemen:


All capitalized terms used herein and not otherwise defined shall have their respective meanings specified in the Contract of Guarantee.

The Guarantee Holder hereby certifies as follows:

1. The Current Amount of Guarantee as of the date hereof is [Amount in Guarantee Currency].

2. The first day of the upcoming Contract Period is [_______], 20[____]. Additional portions of the Guaranteed Investment have been phased-in or will be phased-in such that the amount of the Guaranteed Investment as of such first day of such upcoming Contract Period will be [Amount in Guarantee Currency].
3. No Covered Risk giving rise to a Loss has occurred as of the date hereof, and in accordance with Subsection 12.1(g) of the General Conditions the Guarantee Holder has notified MIGA in writing upon learning of any event or circumstance prior to the date hereof that could cause, or materially increase, the likelihood of a Loss.

4. In accordance with Section 15.3 of the General Conditions, the Guarantee Holder irrevocably elects to increase the Current Amount of Guarantee as of the first day of the upcoming Contract Period, for such Contract Period and each successive Contract Period during the Guarantee Period, by transferring [Amount in Guarantee Currency] from the Standby Option Amount to the Current Amount of Guarantee, so that as of such first day of the upcoming Contract Period: (a) the Current Amount of Guarantee shall be [Amount in Guarantee Currency]; and (b) the remaining Standby Option Amount shall be [Amount in Guarantee Currency].

Sincerely,

[GUARANTEE HOLDER]

By: __________________________
    (signature)

______________________________
Authorized Representative
    (name and title)

______________________________
    (place and date)