



## JARDINE LLOYD THOMPSON ASIA

Press Release

### **Terrorism and Political Risk Insurance In Asia**

*Political risk insurance is a vital part of the jigsaw in promoting foreign direct investment and trade in Asia, according to Ms Melissa Chai, Divisional Director, JLT Risk Solutions Asia, and Mr Nicholas L Robson, Partner, JLT Risk Solutions Limited, who add that this process demands careful consideration and rigorous analysis; any less will only short change the potential of PRI and those who seek to benefit from it.*

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**Singapore, 24 February 2004** – One interesting aspect of the growth of terrorism insurance in Asia is that in some ways, this growth is a mixed blessing for the growth of political risk insurance (PRI) in Asia. Under PRI policies, cover for political violence has been available for more than 30 years, with a particular focus on supporting investment and trade into emerging markets.

This cover can be bought as part of a broader PRI policy or as a standalone cover. The buyer is typically a foreign company looking at an overseas investment, and the scope of cover includes strikes, riots, civil commotion, terrorism (SRCCT), and sabotage, war and civil war. In this context, it is clear that terrorism risk is a component of political violence, and should be considered as such.

Unlike the situation in most developed countries, terrorism risk is not the only form of political violence risks faced by a business operating in emerging markets. The political landscape in many emerging markets exposes businesses to more than just terrorism risk. For example, random events of terror by separatists may escalate to a civil war. Hence, businesses operating in emerging markets may have a false sense of security after they have bought standalone terrorism insurance policies.

### **PRI Marketplace in Asia**

The level of awareness of PRI among corporations and financial institutions operating in Asia has improved dramatically over the past five years. The PRI opportunities in Asia have resulted in a number of company insurance markets (eg. AIG, Zurich, Chubb) locating underwriting expertise in Austral-Asia. Until its recent global restructuring, one of the major multilateral agencies, MIGA (Multilateral Investment Guarantee Agency), also had a presence in Asia.

Following a relatively slow period of reduced trade and investments in 2001-2002, the underwriting players in Asia have recently been reaping the benefits of their presence in the region as trade and foreign direct investment (FDI) pick up. Likewise, regional corporations and institutions have benefited from an improved body of political risk underwriting knowledge to support their trade and investment activities, and protect their shareholders and lenders.

Nevertheless, London is still the undisputed centre of PRI underwriting for Asia risks, and increasingly Bermuda is becoming an important marketplace. Of the three company markets that have an underwriting presence in Austral-Asia, only one has an underwriter physically located in Asia. With continued PRI growth expected in Asia, it appears there is unexploited opportunity for the region's financial hubs to attract more PRI underwriting expertise to be based here.



Premium rates for terrorism insurance will continue to experience downward pressure in 2005, primarily due to the softening property insurance market. This situation may be exacerbated by speculation that the property insurance underwriters may, once again, begin to include terrorism insurance within the main property policies which terrorism insurance within the main property policies which, when one considers our improved understanding of the nature of the terrorism risk today – that it is a form of political risk, very much like war risk is, rather than property damage risk – would be an extraordinary decision.

Some terrorism markets are already showing signs of undisciplined premium pricing. While reduced pricing is undoubtedly a good thing for many buyers, undisciplined pricing inevitably becomes a problem for everybody. It is unavoidable in an uncertain economic environment that the first major terrorism event to hit an insurance market that has lacked pricing discipline will find insurers' reserves wanting and rapid capacity constriction, as well as (likely) resultant rate rises. A semblance of stability and predictability is clearly preferable to pricing volatility in this respect.

As regards PRI, there is an expectation that the soft property market will cause capital providers to divert more capital to better-yielding PRI. The PRI market has traditionally weathered the vagaries of the insurance cycle better than P&C markets, and the unresolved claims situations in Argentina (since 2001) and China (in respect of commodities trade), together with positive correlation to the pricing of debt, should help the PRI market maintain underwriting and pricing discipline.

#### **Challenges For PRI Market**

##### ***The Power Sector***

Asia's power sector has an unfortunate reputation in the PRI market, notably as a consequence of the high-profile problems in Indonesia and India in the late 1990s and early 2000s. On the other hand, Asia is the world's fastest-growing region in respect of power demand. In North Asia, China currently is experiencing a shortage of power despite huge investments in this sector. In Southeast Asia, Indonesia is starting to experience brownouts, while the Philippines has to liberalise and privatise its power sector amid its soaring debt burden.

With the withdrawal of US-based sponsors and some European sponsors from Asia's power sector, emerging markets in Asia have to explore a new investor base for the much-needed investments in their countries. We believe multilateral development banks (MDBs), such as the Asia Development Bank (ADB), are very well positioned to take the lead in providing innovative PRI solutions to attract new sources of capital, particularly within Asia.

Such initiatives by the ADB will encourage private-market PRI insurers to add depth to the marketplace for Asia's power sector. In this respect, we should also consider how PRI can be used to mobilise domestic savings toward the power sector; after all, domestic investors face the same PRI risks as foreign investors, with the critical exception of the currency inconvertibility/non-transfer risk and the associated devaluation exposure, which is so difficult to address for foreign investors and lenders.

##### ***Exclusions***

The claims arising from Argentina have thrown some of the long established exclusions under a PRI policy into the limelight. Attracting the most debate are the losses associated with devaluation, which is an excluded risk from a PRI policy. It has always been clear that PRI insurers do not cover foreign exchange or devaluation loss, not least because of the difficulties in quantifying this risk over a long period and the greater ability of currency hedging specialist to understand and address this risk.

However, there is no real or competitive long term currency hedging product for emerging market



exposures, and with a **JARDINE LLOYD THOMPSON ASIA** very broad PRI devaluation exclusion, there is clearly a gap in product delivery in this area.

In standard form, most PRI policies today will not respond if a loss occurs due to the type of devaluation scenario typical of an economic crisis. However, one needs to look beyond the standard form and consider proximate causes of loss and government actions. Clearly, a PRI policy should be able to respond to direct government action, which prevents payments from being made, irrespective of what movements may have occurred in local currency; similarly if a government institutes currency controls or other extraordinary legislative measures, which reduce the value of an asset to a foreign investor, a PRI policy should be able to respond.

Work does need to be undertaken with underwriters to be more specific about what is included and excluded for specific projects in those economic crisis scenarios that cause many people to consider purchasing PRI policies in the first instance. Other solutions include:

- developing longer term emerging market currency hedge products – we believe that MDBs, government export credit agencies and export-import banks have a key role to play.
- mobilising local currency funding, which naturally addresses currency mismatch issues (as described with respect to the power sector) – if governments are prepared to cede to International law and independent external arbitration for local investors, we believe PRI markets should be able to support such local investors.

### ***Basel II***

The International Convergence of Capital Measurement and Capital Standards (in short, Basel II), published by the Bank for International Settlements (BIS) in June 2004, has mixed implications for PRI. The bad news is that under the standardised approach, the definition of “guarantee” will appear to eliminate the potential of capital relief that PRI may accord to lenders. This is because “there should be no clause in the protection contract outside the direct control of the bank that could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original counter party fails to make the payment(s) due”.

A number of items in the current exclusion list in PRI policies will not satisfy this condition. However, while at face value this may appear to be a problem, it is clear that a policy where the insured can ensure that payment of loss within defined indemnity scenarios does indeed take place (by the adherence to the terms and conditions of such a defined form of indemnity) should also meet the Basle II criteria of a “guarantee”. Further, a conditional document issued by a multilateral agency can already, by virtue of a new footnote to the guidelines, meet the criteria.

On the other hand, under the internal ratings-based approach (presumably for more sophisticated financial institutions), conditional guarantees such as PRI may be recognised for capital relief under certain conditions. The onus is on the financial institution “to demonstrate that the assignment criteria adequately address any potential reduction in the risk mitigation effect”. Even then, Basle II requires that the financial institutions consider the extent to which residual risk to the borrower remains, and the currency mismatch between the guarantee and the underlying exposure is specifically cited.

### ***Justified Proposition***

Taking all the points discussed above, the proposition of a local currency PRI is strongly justified because it should expand the investor base for Asia’s critical sectors, make the devaluation exclusion redundant and –assuming the lenders use the internal ratings-based approach – allow the lenders to achieve some capital relief under Basle II. We should note that Basle II does only offer guidelines, and it is up to local regulators to determine what constitutes a form of regulatory capital relief.



## JARDINE LLOYD THOMPSON ASIA

### **About Jardine Lloyd Thompson Asia:**

Jardine Lloyd Thompson (JLT) Asia is a leading provider of risk solutions, insurance and reinsurance broking, risk management and corporate consultancy services in the Asian region. Employing over 500 industry professionals in ten Asian countries, JLT Asia is ideally positioned to provide new, innovative solutions that enable clients to compete more effectively and to have a positive impact on their financial performance. JLT Asia is also a wholly owned subsidiary of the Jardine Lloyd Thompson Group plc.

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