Strong Capacity Drives Buyer's Market for Political Risk Insurance

BOARD DISCUSSION

Spotlight on Political Risk

Strong capacity and competition driving insurance prices down despite global instability.

Current market offers a rare window of opportunity for insurance buyers.

Multi-country programs are often less expensive than single-country policies.

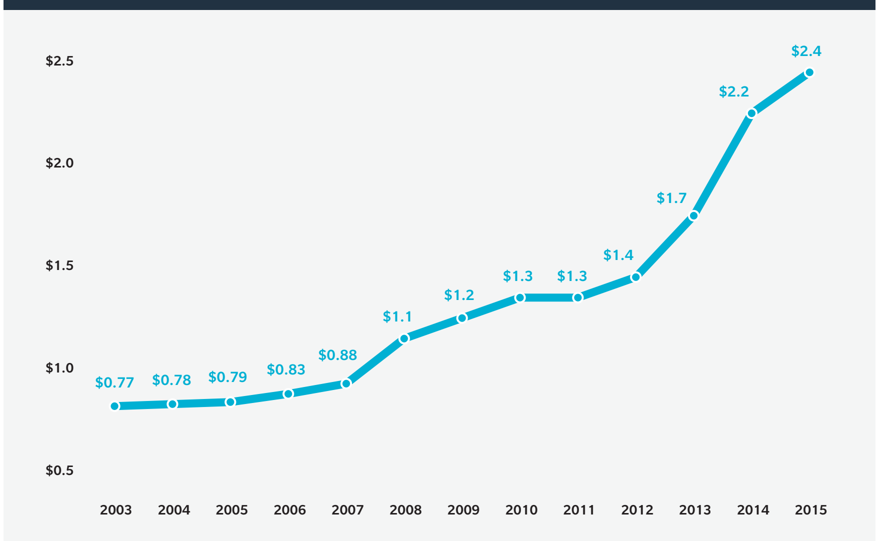
Abundant capacity and strong competition have contributed to a generally favorable marketplace for buyers of political risk insurance globally as the second half of 2015 approaches. Despite growing concerns about global political and credit risks and a recent increase in loss notifications — which will likely translate into some losses for insurers later this year — insurers generally view political risk as an attractive line of business in which to compete. And with pricing at an all-time low, multinational companies are increasingly purchasing political risk insurance to protect shareholder value, support growth in foreign markets, and help secure financing from lenders.

GROWING CAPACITY

Capacity in the political risk marketplace has steadily increased over the last decade, particularly since the financial crisis (see Figure 1). Globally, market capacity now exceeds US$2 billion for a single policy, nearly double the available capacity just six years ago.

This increased capacity reflects a shift away from traditional property and casualty lines toward more profitable specialist classes of insurance. Many traditional insurance lines, such as property and directors and officers (D&O) liability, have become crowded with competitors, contributing to

FIGURE 1 Political Risk Insurance Market Capacity, 2003-2015
Single Risk Capacity (US$ Billions)
Source: Marsh's Credit & Political Risk Practice



prolonged soft pricing and limited underwriting profits. Insurers have also not been able to generate much investment income because of low interest rates, which had led them to expand their product offerings to find new sources of revenue.

Insurers are finding those revenues in political risk insurance and other specialty lines that generally do not correlate with swings in the overall commercial insurance market. Combined ratios for political risk have generally remained below 100 for the last decade (with the exception of 2008 and 2009, at the height of the global financial crisis), indicating profitable underwriting results.

In recent months, insurers have seen an increase in both frequency and severity of political risk loss notifications, stemming from high-risk countries such as Libya and Ukraine and spanning a number of risks, including nonpayment, physical damage, forced abandonment, and currency controls. But the industry's outlook for political risk remains decidedly positive.

"The global political risk landscape continues to be shaped by falling oil prices, geopolitical tensions, and regime change, whether as a result of constitutional elections or otherwise," said Evan Freely, Marsh's Global Credit & Political Risk Practice leader. "But these trends have not yet translated into catastrophic losses for insurers. Combined with the lack of profitability in more traditional insurance markets, this has led many insurers to essentially 'double down' on their investments in political risk."

One example of the industry's growing interest in specialty lines is the recent merger of XL Group and Catlin Group, which the two companies said would allow them to "add immediate scale in specialty insurance." The industry also continues to add underwriting resources in political risk. For example, Tokio Marine Kiln recently announced the hiring of a trade credit and political risk specialist for Asia. Lloyds, Beazley, and others have also opened new offices in Dubai with a focus on political risk and other specialties.

LOW PRICES SPUR INTEREST

This rapidly expanding capacity has buoyed competition in the marketplace. That has driven pricing for coverage of political risk in most countries to an all-time low. In turn, this low pricing has driven greater interest in the coverage among multinational investors.

"Although insureds can pick and choose specific countries to insure, political risk can often emerge in unexpected places," Mr. Freely said. "For this reason, most companies are now purchasing multi-country political risk insurance policies instead of single-country policies."

Multi-country policies can provide coverage for a specific region (for example, the Middle East and North Africa), or a longer list of countries specified by an insured. Purchasing a multi-country policy may also allow companies to insure countries where coverage is often difficult to secure or expensive on a single-country basis, including Argentina, Libya, Mali, Myanmar, Pakistan, Russia, Ukraine, Sudan, South Sudan, Syria, and Venezuela.

Insurers prefer multi-country policies because they signal that insureds are not attempting to adversely select high-risk countries for coverage. As a result, these policies are often available with more favorable terms and conditions than single-country policies. Coverage can also be customized to cover a broad range of risks, including political violence, expropriation, currency inconvertibility, non-payment, and contract frustration.

Meanwhile, multinational companies are increasingly self-insuring political risk exposures through their captives. The number of captive insurers writing political risk insurance coverage nearly doubled from 2013 to 2014, according to *The World of Captives: Growth and Opportunities Without Borders*, Marsh's annual benchmarking report on captive insurance.

Although self-insurance can offer several benefits, political risk losses can be catastrophic. The cost of paying just one claim for expropriation of assets could leave a captive insolvent unless it is well capitalized. Insureds should think carefully about using a captive to underwrite political risk — especially given the current favorable conditions in the commercial marketplace.

Global Political Risk Trends

The following are highlights of key findings from Marsh and BMI Research, a leading source of independent political and credit risk analysis, regarding the major political risks that investors and multinational businesses face today:

Oil prices have rebounded somewhat since January but remain far below those seen from 2011 through September 2014. Persistent low prices could lead to political unrest and have other negative effects on net oil-exporting countries, including Angola, Chad, Congo-Brazzaville, Colombia, Ecuador, Equatorial Guinea, Gabon, Iran, Iraq, Mexico, Nigeria, Russia, Sudan, and Venezuela.

After winning an outright majority in general elections held in May, the UK's Conservative government has announced plans to schedule a referendum by the end of 2017 on the country's continued membership in the European Union (EU). The UK is the EU's second-largest economy and its third-largest country by population; its withdrawal would have a significant effect on the European economy. Elections in Germany and France in 2017 will also be critical to the future of the EU.

In the same UK election, the Scottish National Party gained more than 50 seats to become the third-largest party in the House of Commons. This will likely prompt discussions about a second referendum on Scottish independence, especially if the UK leaves the EU, and embolden Scottish authorities to push for more power in the current government.

In late June, the EU is likely to extend sanctions levied against Russia following its annexation of Crimea in early 2014. US sanctions against Russia will also remain in place until the Minsk II cease-fire agreement between Russia and Ukraine is fully implemented.

In March, a nine-country coalition led by Saudi Arabia launched a military campaign to intervene in the Yemeni conflict. The move highlights tensions between the Saudi government and Iran, which has allegedly been supporting insurgents in Yemen, and also demonstrates Saudi Arabia's willingness to take military action in the region independent of the US.

American and Iranian officials are working to reach an agreement to curtail Iran's nuclear program by the Obama administration's June 30 deadline. But strong opposition to the deal exists in both countries, and presidential elections in the US in 2016 and Iran in 2017 could essentially nullify any agreement.

In December, the US and Cuba announced the beginning of a process to normalize relations between the two countries, which were severed in 1961. If reached, an agreement to lift the US embargo of Cuba would have a significant positive effect on the Cuban economy; talks on the subject began in January. In May, the US removed Cuba from its list of state sponsors of terrorism.

Relations between China and Taiwan could become stressed following January 2016 elections in the latter country, especially if the pro-independence Democratic Progressive Party takes power. Meanwhile, the US and Japan remain concerned about China's assertion of territorial claims and construction of artificial islands and airstrips in the East China Sea and South China Sea. Longer-term, growing instability in North Korea and elections in Hong Kong and South Korea in 2017 will shape the political landscape in the region.

CAPITALIZING ON A BUYER'S MARKET

Organizations sometimes defer discussions of catastrophic risk until they pose an immediate threat. But corporate boards and risk managers should consider how they can protect shareholders from potentially catastrophic exposures, including political risk that can rapidly evolve from a small-scale event into a large-scale crisis, potentially across multiple countries. When that happens, the effect on insurance markets can be devastating; Just days after a political risk threat becomes apparent, coverage may be unavailable for purchase or cost-prohibitive.

That's why it is important for organizations that have not historically purchased political risk insurance to considering doing so in the current favorable marketplace.

For companies that already purchase coverage, now may be a good time to consider expanding a political risk insurance program.

"A just-in-time approach to political risk can leave a company highly vulnerable when it needs coverage the most," said Mr. Freely. "Instead, multinational companies should plan ahead and take advantage of buyer's markets when they develop. Now is the time for risk managers to work with their advisors to negotiate favorable pricing, terms, and conditions to build effective insurance programs that protect their organizations' bottom lines."

ABOUT THIS BRIEFING

This report was prepared by Marsh's Credit & Political Risk Group, which helps businesses to manage risks related to political violence, government breach of contract, sovereign or commercial default, expropriation of investments or assets, currency inconvertibility, and more.

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