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Using Political/Credit Risk Insurance to Maximize Financing Opportunities

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I. INTRODUCTION

What is a bank doing in the insurance brokerage business? How could Bank of America (BofA) become an insurance broker, considering that a body of law exists which creates a wall between banking and insurance, and that the pace of deregulation in this area appears to have come to a grinding halt? The Bank Export Services Act[1] contains a provision permitting a bank export trading company to act as broker for export-related insurance.[2] Since banks, rightly or wrongly, view themselves as having a certain expertise in country risk evaluation, brokering political risk insurance is a logical and legal first step into the insurance field. Insurance brokerage also provides a unique position from which to understand and exploit the nexus between financing techniques and political risk insurance.

From the underwriter's standpoint, the philosophy which underlies political risk insurance is that the insured should enter into the transaction in the good faith belief that all will be well. This coverage should be purchased only as "sleep insurance" against unforeseen problems. This view contradicts the often stated desire of the United States Congress that the Overseas Private Investment Corporation's (OPIC) program embody "additionality," in other words, that demonstrate that the project would not have gone forward *but for* the insurance.[3] Private insurers, however, are not bound by similar policy considerations. The client who

1. 12 U.S.C. § 1843 (1982).

2. 12 U.S.C. § 1843(c)(14)(F)(ii) (1982). Certain states, including California, however, do not permit banks to engage in insurance brokerage under any circumstances, despite the federal grant of authority. Thus, the services of BankAmerica Insurance Brokers, Inc., are not available to California clients.

3. This is the opposite of OPIC insurance, which required disclosure to, and approval by, the government of the project country.

will not sign a contract without first arranging insurance coverage is, to some extent, waving a red flag, suggesting that perhaps he or she knows in advance that the deal is somehow suspect.

This example illustrates that frequently the real reason companies purchase political risk or export credit insurance is less for their own corporate peace of mind than to satisfy their bankers who are funding the transaction. Despite the fact that it is extremely rare for a bank to be permitted to purchase political risk insurance in its own name, it is banks which are often more concerned about protecting their interests.

Banks differ in the weight they place on political risk insurance as collateral for their credit. While banks will generally accept an OPIC or Foreign Credit Insurance Association (FCIA) policy as security, this is by no means true of private market policies. Such policies unquestionably enhance a transaction from a credit point of view. The so-called conditionality of the coverage, however, leads many banks to insist that even an insurance-backed loan must be subject to its internal country risk guidelines.

For example, imagine that Jones Company were to approach Smith Bank to finance its sales on credit terms of medical products to Egypt. The financing could take the form of a supplier credit to Jones, a confirmation of a letter of credit issued by an Egyptian bank, or a discounting of the Egyptian promissory note. Smith Bank evaluates the transaction and decides it is creditworthy, but already has large exposure in Egypt. Smith Bank may therefore require Jones Company to obtain a political risk insurance policy under which Smith Bank would be designated as the loss payee in the event of a claim. While Smith Bank will now be far more comfortable with the deal, it will still show the loan on its books as an Egyptian risk. Smith Bank's lawyers will examine the policy and discover that it is not, nor is it intended to be, an unconditional guarantee that Jones Company (and thus Smith Bank) will be indemnified by the insurer if the Egyptian buyer does not pay for the medical products. As in any insurance policy, political risk policies contain warranties and conditions, the breach of which voids the policy, as well as exclusions under which there is no coverage.

Certain banks, however, take a more aggressive stance in using political risk insurance to back credits. Their analysis of the conditionality problem breaks down the possible events of nonindemnification into those which are under the control of the exporter and those which are not. Examples of the former include an exporter's failure to perform its obligations under a sales contract, or the breach of a warranty which prohibits disclosure of the existence of an insurance contract to the government of the buyer's country. An example of when the insured would not have control is an exclusion such as a loss due to war between the five Great Powers—United States, Soviet Union, China, England, and France—or between the buyer's and the seller's countries.

Assuming recourse back to the client for those situations where the policy does not respond due to the client's own act or omission, some banks are now willing to bear the risk of those events of nonindemnification which are outside the control of the exporter. The loan may then be carried on such a bank's books under the limits of the *insurer's* country. Thus, in the Jones Company example above, a more aggressive bank than Smith Bank would not have to exhaust its precious Egyptian country capacity to finance the Jones Company sale. Rather, it could assume a much more active role in the trade finance area generally.

Improved financing terms can often be obtained, however, even from a bank such as Smith Bank, by the use of political risk insurance. Minimizing the risk of nonpayment should result in lower interest rates and possibly longer payout periods. It should also permit exporters to be more competitive by enabling them to offer a buyer better terms than his or her bank might otherwise accept.

II. FINANCING TECHNIQUES

My comments have thus far focused on financing traditional export transactions, but there are many other kinds of financing techniques in which political risk insurance can play a role.

A. Project Financing

A lender will frequently fund a project by looking to the cash flow of the project for repayment, rather than to the investor's balance sheet. When the project is located in an unstable or potentially unstable region the purchase of political risk insurance to protect against noncommercial loss seems only prudent.

The private insurance market has a role to play in such transactions where OPIC coverage is unavailable, or excess coverage for OPIC is desired. Generally, OPIC insurance is preferable because it may often be obtained on a noncancellable (except for nonpayment of premium) basis for twenty years. The private market only offers uncancellability for three years on a rolling horizon. In addition, OPIC provides coverage for loss due to war, revolution, insurrection, or civil strife.[4]

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4. Among private insurers only Chubb offers civil war, and even occasionally war cover-

OPIC's finance group has a loan guarantee program which may provide an even more effective financing tool. OPIC will give its full faith and credit guarantee of payment out of the cash flow of the project. In the event that an installment is overdue by five days, for whatever reason—political or commercial—OPIC will reimburse the lender. The advantage of this technique is that it facilitates the raising of funds from an array of sources beyond commercial banks. Institutional investors, such as pension funds and insurance companies, can safely invest in projects which would otherwise be far too risky for their portfolios. This can be achieved directly or indirectly by resort to capital markets. The Project Finance Group of BofA was the first to utilize the latter mechanism when it won the mandate to obtain funds for the *Ok Tedi* copper and gold mining project in Papua, New Guinea. The bank raised several million dollars by fronting the issuance of commercial paper which institutional investors purchased on the open market.

B. Credit Enhancement

The concept underlying OPIC's loan guarantee program has also been adopted by the private sector for certain types of risks. Certain established insurance companies, as well as new entrants, provide financial guarantees for such things as municipal bonds, industrial revenue bonds, mortgages, and corporate issues. The idea is to take a good risk, or a package of good risks, without ready access to capital markets (e.g., first-time borrowers or privately-held, and therefore unrated, companies) and to use the solid credit rating of the financial guarantor to "enhance" the credit.

American International Group (AIG) pioneered the use of credit enhancement with respect to export transactions. Originally in conjunction with a group called Trade Finance Corporation (TRAFCO) and Salomon Brothers, AIG would put its AAA rating behind the credit of selected foreign buyers. TRAFCO would act as the source for the transactions and then bring them to AIG. If AIG believed that the buyer was a good risk, it would issue a pool insurance policy covering one hundred percent of principal and interest on the buyer's promissory notes. The exporter would sell the promissory notes to TRAFCO, which would issue securities for Salomon Brothers to sell to institutional investors, often at fixed rates. The paper was marketable because it bore AIG's AAA

age, but it must be purchased in conjunction with an overall property insurance policy, and inconvertibility coverage is not available.

rating (one of a very few insurers to have such a rating).[5]

The TRAFCO program kept the lawyers for all the parties very busy because of the tremendous documentation required. The exporter would usually have to collateralize the transaction so that AIG would not be out-of-pocket during the waiting period, and because there were various events which would trigger recourse back to the exporter. Still, AIG insured over $500 million of TRAFCO paper.[6] This permitted exporters to offer attractive terms to their foreign buyers in countries such as Brazil and Guatemala.

AIG and TRAFCO abandoned their exclusivity agreement approximately one year prior to the writing of this article. TRAFCO still exists, and attempts to put together similar deals by locating appropriately rated backers on a case by case basis. AIG is still in the credit enhancement business, but it has changed its focus. Exports of Less Developed Countries (LDCs) will generally no longer be eligible. Christine Giangreco, who runs AIG's credit enhancement program, once said that the:

> [the] credit enhancement transactions we undertake will reflect a higher calibre of credit risk than our overall political risk portfolio might contain. We suggest that the markets we would like to consider for credit enhancement are the OECD [Organization for Economic and Community Development] countries, and second-tier countries which still have reasonably good credit ratings on their own. We cannot, and will not, consider any transactions involving debtor nations with balance of payments difficulties or [which] have a history of late payments.[7]

Despite AIG's more conservative outlook, there is still room for innovation in this area. Regulators, however, are scrutinizing the financial guarantee business in all of its aspects. The future merits watching.

C. Countertrade

Increasingly there are circumstances in which a sale cannot be consummated simply for cash or credit. For many countries, hard currency is a luxury that must be carefully rationed. Some countries have passed

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5. Both Standard & Poor's Corporation and Moody's Investor Service Inc. currently give AIG a rating of AAA. (The Moody's rating is applied to National Union Fire Insurance Co. of Pittsburgh, Penn., an AIG company.) Only four other insurance companies merit such a rating from Moody's, while Standard & Poor's awards it to at least 33 other companies. BUSINESS INSURANCE, Oct. 20, 1986, at 12.

6. Interview with Christine B. Giangreco, Assistant Vice-President, AIG Political Risk Division (Oct. 23, 1986).

7. Unpublished speech to Women in Political and Credit Risk, New York, N.Y. (June 5, 1985).

laws that require certain imports to be offset by countertrade obligations. As a result, countertrade in its various forms is becoming a more acceptable means of trade.

Few trade mechanisms are as rife with legal and practical pitfalls. The thicket of import and export regulations and license requirements, the usual need for warehousing or storage of the traded commodities, and the problem of assuring quality control are just some of the issues which traders, trade-finance companies, and lawyers face in reaching the ultimate goal of providing the exporter with cash.

Political risk insurance should always be considered when there is a time lag between the fulfillment of one party's obligations and those of the other trading partner, or when that partner is located in a country perceived to be unstable or financially weak. For example, a United States exporter might provide equipment to an LDC under a payment mechanism wherein the LDC is required to deliver a quantity of copper equivalent to an agreed dollar amount at an agreed place and time or, failing that, to come up with the agreed-upon amount in hard currency. The exporter may wish to insure against nondelivery of the copper on a timely basis, or failure to pay hard currency in its stead. Alternatively, the exporter may advance funds to the LDC to enable it to produce the copper. This is known as pre-export financing, and the exporter may then insure that it will get its advance back if the copper is not delivered.

It is always a good idea to make the insurance policy respond to the possibility of *financial* default in these situations. To quote Frank Boylan, one of the grand old men of political risk insurance:

> [A] creditor can establish an irrevocable obligation on the part of an obligor to pay a dollar amount owed, but he cannot create an irrevocable obligation to deliver a commodity—the seller of that commodity may be able to rely on *force majeure* to relieve . . . him of all or a portion of his obligation to deliver. If, for example . . . a crop were completely destroyed by flood, I would expect that the supplier of that crop would be relieved of his [or her] obligation to deliver at the agreed time and amount. If, however, he is obligated to repay funds advanced against that delivery, this would be an irrevocable obligation that should not be affected by the *force majeure* condition.[8]

It is by no means certain that insurers will insure the financial component of a countertrade transaction, as opposed to mere nondelivery. The purpose of employing countertrade in the first place is because it is frequently known that the importer can not come up with cash. Yet,

8. 1(1) COUNTERTRADE & BARTER Q. 9 (Winter 1984).

there have been cases when the underwriter has been persuaded to insure the *force majeure* risks as well. This, however, is uncommon.

Nondelivery insurance is also useful in pure import transactions, in which the importer must make a down payment or prepayment on the goods. Alternatively, if the importer takes title to the goods in the exporter's country and stores them before reselling them, he or she must protect against confiscation of his or her goods or "deprivation"[9] of the right to reexport them. One of our clients is a sugar trader who hopes to use a blanket political risk policy based on nondelivery and deprivation concepts to maximize his financing flexibility. He purchases sugar in Country A by prepayment and warehouses it; he then sells to Country B, usually by placing the sugar in a local warehouse from which purchasing agents draw upon it for cash. What he cannot sell, he reexports to Country C on the same basis. His bankers will provide him a line of credit. They are comfortable that he will receive both the sugar for which he has paid, and payment for the sugar which he sells. A separate credit decision, therefore, is not required for each individual transaction. Naturally, certain countries will be excluded from the policy, but all in all the sugar trader will be able to expand his business by responding quickly to trading opportunities around the world.

D. Loan Service Interest

One of the principal badges of legitimacy for a developing country is to have its own national airline. In some countries this is merely a sop to the leader's ego, but in other countries air travel is essential to internal communication and development. How can financially strapped countries afford to buy aircraft when no prudent bank would finance such a sale and no self-respecting underwriter would insure against nonpayment?

Innovative brokers and underwriters in Lloyd's of London came up with an answer. Rather than sell the planes, aircraft manufacturers *lease* them to the foreign (usually government-owned) airline. If the airline successfully meets all the payments, it takes title to the aircraft at the expiration of the lease. If the country fails to make the payments, however, the seller has the right to repossess and resell the plane. The insurer might not insure the lease payments, but *would* protect against the lessee's failure to delicense and return the aircraft to the lessor. The bank

9. "Deprivation" is a term of art used in insurance policies to relate specifically to a government's unjustified refusal to permit a foreign owner to reclaim goods or equipment to which he or she has title.

could then use the plane as collateral for its loan, and would be sure of *access* to its collateral in the event that loan payments are not made.

III. CONCLUSION

The foregoing are merely examples of the many ways in which political risk insurance can be tailored to improve opportunities for financing. It is by no means, however, a panacea for lenders. In addition to the conditionality issue described above, the policies normally embody major limitations on coverage such as: an insured percentage of less than one hundred percent; no coverage for interest during what may be a lengthy waiting period (although occasionally an insurer may be willing to cover all or part of this risk); and the potential for a loss in excess of the limit of liability. A bank's rights may also be adversely affected by acts or omissions of the policyholder, not just with regard to his or her dealings with an overseas customer, but also in relation to the insurer in such areas as premium payments, reporting requirements, or due diligence in pursuit of payment from the buyer.

There is always an inherent tension between banks and underwriters when an insurance policy is used to secure credit. This is borne of the parties' diverging attitudes toward risk assumption. Underwriters, although occasionally forgetful of this fact, are in the business of taking risks. They expect to pay reasonable claims and earn their profits by taking in more in premium than they pay out in claims.[10] Yet, a cardinal underwriting principle is that risks should be shared by all parties, including the bank, and should not be completely thrust onto the insurer.

Banks, by contrast, earn money from the interest on their loans; they do not *expect* to have losses. They expect their loans to be repaid, and they take every possible measure to ensure repayment. They want the client to bear all of the risk, or, alternatively, an insurer to bear all of the risk. Thus, in a given transaction, underwriters must be convinced that valid reasons exist for the bank not to accommodate the risk itself. Reasons may become valid when some of the differences between insurers and financial institutions, in dealing with country risk, are explained. This is particularly true with regard to the differences in constraints on aggregation of risk and their respective approaches when considering use of available capacity.

A bank examines the country capacity problem from a macro point

10. Actually, this has not been true recently for most of the property and casualty insurers—they pay out as much, if not more, than they take in, and make money by investing their reserves—but it remains true for political risk insurers.

of view. Based upon a thorough study of economic and political factors, the bank will determine what its total exposure should be in a given country. For developing countries, the country guideline will often be considerably lower than the demand for credit in that country. Thus, loan officers will have to compete for the available capacity for their clients.

Underwriters also establish country limits, but these are more a function of risk spreading and treaty limitations. Rarely have risks been turned away because of country capacity restrictions. Brazil and East Germany are examples in which insurers declined good business because of portfolio imbalance. While underwriters, of course, engage in country risk assessment, they generally focus more on the individual transaction and the likelihood that it will be completed without mishap. Even the poorest countries pay for certain key commodities or can provide countertrade offsets. The trick is to identify the country's priorities. Basic foodstuffs are always important, as are medical supplies, especially for countries engaged in war. On the other hand, it did not come as a surprise when brokers were unable to find anyone to insure the sale of hand-cream to Nicaragua.

In addition to assessing the priority of a transaction, underwriters consider several other factors in deciding whether to insure a risk. Of central importance to this inquiry are the exporter's experience in dealing with his or her buyer, or with other buyers in the same country, and the specific risk-minimizing details of the contract. A large and prestigious client is more likely to receive favorable consideration than a small unknown company for a similar transaction. This is because buyers and their governments will supposedly be less prone to damage their relations with a well-known multinational (although this can of course cut both ways).[11] For many insurers, especially Lloyd's of London, the total premium the client pays to that insurer for all lines of business may influence the underwriter to give more generous terms.

As bankers and insurers grow better to understand and accept each others' philosophies and requirements, the possibilities for concluding mutually beneficial deals and increasing trade finance flows should increase dramatically.

11. For example, if a new government wishes to enhance its antiimperialist credentials, it must target precisely the largest and most visible multinationals for expropriatory or other discriminatory action.