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When Linn Williams asked if I could participate on this program, I was pleased to say yes. Only later did I discover that Linn had billed my address as New Developments in Private Sector Political Risk Insurance. The major development apparent in today's environment is actually a continuing contraction in the flow of trade and investment to developing countries and, therefore, a reduction in our business. But it is obvious that, as businessmen, we must respond to this trend by finding new applications for our insurance capabilities and ways to support the trade that is taking place, which is the subject I will try to emphasize in my talk.

I will try to strike a balance in my remarks between discussion of the political risk insurance coverages and more issue-oriented concepts. This should enable me to use this presentation to address the issues that impact most directly the value-added advice you may be called upon to provide to your clients.

I have organized my comments around three major headings:

(1) Background on the structure and operation of the private sector political risk and export credit market;

(2) A review of the coverages available from the private market, with particular emphasis on the more nontraditional and innovative applications of the insurance capabilities; and

(3) Some considerations to keep in mind if you become involved in the use of these insurance products.

Now let's consider some of the issues that will have a significant impact on the future development of the private sector market.

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I. Background

I believe it is quite important to understand the origins and evolution of the private sector market, as well as its current structure, in order to appreciate how this market functions. Much of the tradition built up over the years still influences strongly the types of coverages available in the private market and the terms and conditions of the policies that are written.

Political risk insurance emerged from the marine insurance coverages provided to exporters and shipping lines and, to that extent, has been around for an extended period of time. As might be expected, Lloyds was then, and remains today, a major factor in the political risk market. The development of a more broadly based private market probably dates back ten to fifteen years with the entrance of other leading players, such as American International Group. The number of companies who participate in this business is not great, however, with even fewer insurers exercising any leadership role.

The coverage initially offered by the market was protection against confiscation, expropriation, or nationalization of assets or fixed investments. Over time, other coverages became available, notably protection against loss arising from government actions that interfere in the delivery of goods or performance of other contract obligations. This "contract frustration" insurance covered a multitude of events, such as trade embargoes, license cancellation, premature cancellation of contracts, or nonpayment by a government organization for goods or services. This category of contract frustration or repudiation coverage, particularly relating to the guarantee of payment obligations, is the category that has grown most rapidly and has brought the political risk into the mainstream of trade and trade finance. Other coverages, such as pure currency inconvertibility and wrongful calling of bid or guarantee bonds, are also offered by the market, but are much smaller. The concept underlying all these products is that they provide protection to the insured against fortuitous, unforeseen events arising out of government action, perhaps itself an arguable thesis in today's environment of debt reschedulings and balance of payments problems.

The private sector also provides a market for export credit insurance, although its capacity is smaller and of more recent vintage. This insurance protects against a private buyer's failure to pay for goods or services, whether occasioned by commercial default or bankruptcy, or by failure of the local exchange authority to make available adequate foreign currency. Although the two programs overlap in the coverage of transfer risk, they are perceived by the market as quite separate for several reasons. Chief among them is the fact that Lloyds underwriting syndicates, by virtue of internal regulation and agreement, are prohibited from insuring against commercial default or financial guarantee type exposures. Again, coverage provided under export credit programs brings the insurance industry in as a direct participant in the trade finance arena.

As part of this background discussion, I also wanted to provide a brief description of the functioning of the insurance and reinsurance market. For this, it is best to talk separately of the Lloyds market and the non-Lloyds, or company, market. Lloyds is composed of hundreds of underwriting syndicates under separate management, some of whom choose to participate in various types of political risk insurance. Requests for insurance are handled on a one-by-one basis by brokers who first gain support and negotiate terms and conditions with syndicates specializing in political risk insurance, and then, on the strength of the "leaders" participation, attract other syndicates to sign on for a percentage of the risk exposure. To increase the efficiency of this process, some standing commitments, known as "line slips," exist, where a number of syndicates automatically agree to participate on risk provided a specific group of leaders have committed to the transaction.

The company market functions on the basis of reinsurance treaties that commit participating reinsurers to a specific percentage of each and every transaction underwritten by the primary or "lead" underwriter. There are only a few political risk treaties of any significance in existence today, the largest of which is managed by AIG Political Risk. Because such a treaty is a standing obligation to accept liability without direct involvement in individual decisions, the treaty, both in writing and through industry practice, spells out the limits and parameters of the coverages that can be underwritten. Interestingly, Lloyds syndicates participate as reinsurers, along with the direct business, on almost all political risk treaties. These treaties are annually renewable by participating reinsurers, although reinsurers remain on risk until expiration for all policies written during that treaty year.

There are two points to be made. First, for a high hazard business such as political risk that requires broad reinsurance participation, overall participation is rather thin. Second, the annual nature of treaty negotiations and individual risk decision-making that characterizes Lloyds makes this market quite fragile. Capacity, in the form of capital, can quickly shift away from this business if the actual results or prospects fall below expectations. To sustain our momentum in this business, and prevent a shift away from the more innovative application of these coverages, we must approach the subject of trade finance with a great deal of caution.

One last background comment is the positioning of the private market vis-à-vis the wide variety of national schemes such as OPIC, FCIA, EGGD, COFACE, etc. We would regard our coverages as both competitive with, and complementary to, those programs. The private sector obviously lacks the resources to provide the long-term commitments of the national programs and is constrained also by the need to be profitable, an objective well beyond the reach of the national schemes today. But we can act with more independence from government policy decisions, and we hope with more flexibility and responsiveness as a result. Our goal, over time, is to find ways to generate more cooperation with the public sector to the benefit of all concerned.

II. New Political Risk Insurance Coverages

Let me recap the forms of political risk insurance coverage available today from the private market. Broadly, these coverages included protection against confiscation, expropriation, or nationalization; license cancellation, nondelivery, embargo, or other events of contract repudiation or frustration; currency inconvertibility; wrongful calling of guarantees; and, comprehensive export credit insurance. Singly or in combination these coverages traditionally have been used to protect investors, contractors, exporters, and financial institutions against political and/or credit risks. As will become clear, these coverages are generic and can be applied in a variety of ways.

It is also worth noting, more specifically, the parameters of insurable transactions and the capacity available in the market today. The maximum policy term for political risk transactions is three years, and for export credit the maximum term is five years. The shorter term for political risk is partly due to underwriting considerations, but also matches the three-year accounting cycle used by Lloyds, the major writers and reinsurers of this business, in managing their syndicate books. Individual policies can, however, often be rolled forward annually to maintain continuous cover on long-term investments.

Market capacity varies by type of transaction and over time. For example, AIG Political Risk in 1986 has the capacity within its reinsurance treaties to insure individual political risk transactions with exposure exceeding forty-five million dollars. Additional capacity can often be obtained from other underwriters to increase this limit further, perhaps three to four times this limit for simple expropriation risks and one and one-half to two times this amount for other types of coverages. For export credit, the policy limit per buyer available in the market today is generally less than ten million dollars. In part due to issues unrelated to political risk, aggregate capacity available in the market has declined since its peak in 1983, when AIG Political Risk alone controlled single risk capacity of approximately seventy million dollars per transaction.

I have identified four areas where we see a potential or emerging demand for political risk insurance applied in a nontraditional way. Not all of these developments will be equally successful, but each is worth mentioning.

1. *"Securitization" of trade finance receivables for sale to large institutional investors.* As early as 1983 AIG Political Risk began to experiment with the packaging and securitization of trade finance obligations, an activity that paralleled the efforts to securitize other financial assets, such as mortgages, car loan receivables, etc. Our initial activity was known in the market as the TRAFCO program, which was the name of the firm that provided the packaging and servicing of the trade finance securities. This program also involved Salomon Brothers as the placement agent. From 1983 through 1986 this program generated approximately five hundred million dollars in trade finance securities placed with institutional investors.

The program was marketed to exporters as an incremental source of trade finance available on either a fixed or floating rate basis. The underlying export transaction was insured by AIG Political Risk and purchased by TRAFCO. Because the political risk or export credit policy issued contains certain exclusions, waiting periods, performance warranties, and coinsurance features, this purchase was with specific recourse to the exporter. These trade receivables were packaged by TRAFCO into securities in amounts from fifteen to seventy million dollars. In order to obtain an AAA rating for these securities, an AIG insurance subsidiary, National Union, would issue a second "pool" policy that was a full faith and credit guarantee of principal and interest, taking the underlying political risk policy and recourse to the exporter as security.

At the moment we are not pursuing this type of business, although TRAFCO itself is still active. The program as originally structured had some flaws, partly impacting its competitiveness against its financing sources, which we believe can and will be worked out. The concept of providing a conduit financing vehicle for insured trade obligations is basically sound and can provide a convenient program for exporters. In fact, we believe the concept can extend easily beyond pure trade finance to other structured financing transactions where political risk insurance can provide an element of security that will assist in either making such transactions feasible or lowering the net cost of funding.

One possible constraint on the emergence of this type of business is the increasing regulation of the financial guarantee insurance business. Any significant capital standards may impact these financing programs, as well as the availability of the underlying insurance itself.

2. *Insurance of countertrade, barter or other non-cash-based trade transaction.* As balance of payment conditions in the developing countries

have deteriorated, the volume of trade with these countries has declined and/or is increasingly done on cash terms. A second trend we see is the return to the traditional mechanism of self-liquidating trade transactions. The whole concept of countertrade, a part of this trend, is in fact not new, but is a return to these traditional trading approaches.

The private political risk insurance industry is particularly well positioned to facilitate this type of trade and trade finance and has already been quite active. The entire basis of political risk insurance is to provide protection against governmental actions that interfere with the fulfillment of a contractual obligation or the failure of a government or pari-statal organization to perform under contract. Whereas almost all commercial banks have problems dealing with nonmonetary transactions, the political risk insurers would actually prefer transactions that involve performance risks to those involving payment risks. We have been involved extensively with these types of transactions for the past several years, and see the demand growing very rapidly in the future. Three basic types of transactions are in the market today:

- pre-export finance or the advance purchase of commodities or goods;
- delivery of goods in payment for capital equipment, raw materials, or other factor inputs;
- countertrade arrangements used to retire existing debt, often at a discount.

We can guarantee that the host government does not interfere with or prevent the delivery of the product or renege on the agreement to allow an offset against the export proceeds. To the extent a private supplier is involved, we can also use the export credit treaty to provide protection against its default. With our assumption of the performance risk, these transactions can become "bankable" and, in fact, we have used the TRAFCO program for several pre-export finance transactions.

3. *Insurance of debt/equity swaps, equity funds or other efforts at LDC privatization.* This third area is one where there is a lot of interest and potential, but little actual activity to date. Most of these schemes would involve the guarantee of normal investor/ownership rights, currency inconvertibility or other specific rights contractually committed to the investors. Since the concept of privatization is rather new, no real track record has been established vis-à-vis the commitments given by the host governments. Most investors are, therefore, naturally reluctant to proceed in the absence of some form of third party guarantee. The private sector political risk industry is eager to have the opportunity to develop programs to meet the needs of investors and host governments. While there are likely to be issues to overcome, we are confident that the private industry can meet this need and provide capacity of one hundred million dollars

or more per country. I would encourage those of you involved in this process to sit down with us to discuss situations that may come up.

I might also mention another related area, which is the proposed creation of "trade credit certificates" that could be used to balance the foreign exchange made available to pay for imports with foreign exchange generated by exports for an individual country. Such a clearing system would issue these certificates to exporters and provide the right to receive foreign exchange to pay for a similar quantity of imports. These certificates could be bartered, sold, or traded on a secondary market. If this mechanism develops, the private market also would be willing to guarantee country performance in honoring these trade credit certificates.

4. *Development of export credit guarantee and financing programs for newly developing countries.* One of the chief advantages the private market enjoys vis-à-vis the national export credit schemes is that we are not concerned with country of origin of goods or services. As a result, the private market has traditionally filled the regulatory or policy gap created by such national constraints. This provides an opportunity for the private market to work together with companies or financial institutions in countries such as Brazil, Korea, or Hungary to provide political risk or export credit insurance for their exports. We are already beginning to see this opportunity emerge. This activity is taking two forms.

First, we see a substantial increase in the demand for our political risk and export credit facilities from large exporters and contractors from these countries. This is particularly necessary as these countries encounter resistance to further export penetration of the OECD markets and are forced to consider development of new LDC markets for future growth.

The second possibility, and one we are actively cultivating, is the use of our insurance facilities as a mini "official" export guarantee insurance program. To compete effectively for export markets it will be necessary for developing countries to provide their exporters with appropriate risk management techniques and access to adequate liquidity for supplier credits. Our insurance facilities can deliver these risk management skills and, by utilizing the financing programs described earlier, can also provide access to sources of hard currency financing. Obviously, such programs would need to be done on a profitable basis, and so would not be exactly the same as national schemes of the OECD countries.

I have tried to give a brief profile of the activity developing in four relatively new areas of political risk insurance that we are excited about. We are looking at, or hope to introduce in the future, a range of other innovative applications of insurance capabilities to trade and investment flows. Some of these include a comprehensive leasing product that would combine expropriation, lease payment, and residual value coverages; coverage against consequential loss due to business interruption arising from governmental actions; a package of political risk and terrorism/civil insurrection coverages, the latter of which is also presently offered by AIG; and, tender exchange rate insurance for tender bids in foreign currencies. As I mentioned earlier, we also hope to find ways to work with national schemes in the U.S. and Europe to provide an even more comprehensive package of coverages and increased capacity to our insureds.

III. Considerations in Using These Facilities

One of the primary considerations in the placement of any insurance coverage is the quality of, and security offered by, the insurer with whom you are dealing. Selection of an insurer, as well as negotiation of policy terms and conditions and price, are the primary services of insurance brokers, who are equally active in political risk insurance. The key distinction with regard to this type of insurance is that there are really only two markets that offer significant capacity: AIG Political Risk and Lloyds. Also, since Lloyds syndicates are active reinsurers of everyone writing this business, the policy coverages and limitations are somewhat standardized, although what each company is prepared to write and how can vary significantly.

I would suggest that it is good practice to work with a knowledgeable broker or contact us directly for advice early in this process of structuring any transaction. Often we can help identify the insurable risks and, with you, structure the deal in such a way that it can be insured. Other than this, I would offer the following caveats regarding these insurance coverages:

1. Political risk and export credit insurance are not "blanket" guarantees but are insurance contracts that provide indemnification for loss arising from specific events and under well-defined circumstances. There are a number of exclusions, performance warranties, waiting periods, and coinsurance features built into all the policies. Both you and your clients should understand fully the terms of the policy and not simply assume that the insurance will respond to all possible events of loss.

2. These insurances should not be viewed as protection of cash flow, but rather protection against loss of the net asset value of receivables, working assets, or other investments. These policies generally carry significant waiting periods, from 180 to 720 days, and we do not indemnify for interest during the waiting period. This issue can often be a source of great misunderstanding with insureds who may be using this insurance for the first time.

3. The use of political risk insurance for transactions where the sole or primary exposure is a "banking" risk—i.e., payment risk—is probably

neither appropriate nor cost effective. Our insurance contract, since it is not an on-demand, full faith and credit policy, is inherently inferior to a letter of credit or other negotiable banking instrument. As such, we are always skeptical of transactions that come to us where the risk could be assumed by a bank, since it probably means something is wrong with the deal. Our underwriting will reflect this skepticism and, if we are prepared to commit our capacity, we will expect a healthy premium rate.

4. Our underwriting process relies heavily on the representations and warranties contained in the policy, particularly as they relate to knowledge the insured might have about circumstances that could give rise to loss under the policy. Since we are by definition adversely selected against in the transactions we see, we regard this business as one that must be conducted on the basis of utmost good faith. In this regard, you should advise your clients to be completely open and honest in the representations they make to the insurers, since it is not our practice to undertake substantial independent investigation of the information they provide to us. This can be a major problem in the event that a claim arises and we find that the insured has not been totally forthright.

5. In the event that a default or loss occurs in connection with an insured transaction, it is the desire of the insurers not to become immediately involved. The purpose of the waiting period is to provide time for the situation to cure and to avoid disruption in the normal commercial relationships between exporter and buyer by virtue of our own efforts to recover. Because we rely on the insured in this regard, we expect him to behave as if the transaction were uninsured and to take all actions necessary to resolve the problem. If this minimization of loss is not done by the insured, it will impact coverage.

These were just a few brief thoughts on things to keep in mind when considering the use of political risk insurance. Again, I believe the key is to make certain that it is the right product for the specific transaction and to have realistic expectations regarding what the insurance coverage actually guarantees.

IV. Conclusion

If I may, at this point, I would like to return to what I referred to at the beginning of my talk as major issues faced by the private political risk insurance industry. The industry is at something of a crossroads in its development. I believe it is particularly appropriate to speak to groups such as this about the issues that bring us to this juncture, since many of you will have an influence on how this matter is eventually resolved.

The primary issue I am referring to is the wholesale rescheduling of debt by third world countries. As I mentioned, our contract frustration policies have been used increasingly as a guarantee against nonpayment by governments. As a result, the industry has been pulled into reschedulings of trade debt undertaken by some countries and, of even more concern, London Club reschedulings where we have worked together with commercial banks or other financial institutions.

We see reschedulings as a creation of the commercial banks and multilateral agencies. While not ideal, this mechanism at least partly meets the needs of the banks by preserving the assets on their balance sheet and ensuring that interest is paid with some regularity. Unfortunately, this mechanism has the opposite impact on the insurance industry.

When a rescheduling takes place, we are obligated to indemnify our insured once the waiting period has expired. This paid claim comes directly from our surplus, or equity capital. Accounting practices in the insurance industry absolutely prohibit carrying on the balance sheet prospective salvage associated with a paid claim, so newly issued promissory notes do us no good. Even if we are successful in avoiding the paid claim, it is still necessary that we establish a loss reserve against this potential obligation, which would further reduce our surplus and negatively impact our capacity to write business.

A second and equally fundamental problem is the structure of our reinsurance treaties. Our treaties are annual contracts that must be renegotiated every year. In order to attract participation of reinsurers, we must demonstrate that the business produced has been profitable. This is one of the chief reasons that we limit the tenure of our policies to three years. When we have paid claims, or reserved against loss, and these obligations are rescheduled over five- to ten-year time frames, it is impossible for us to render meaningful accounts. Also, since our treaties are annual contracts, and we may have substantially different reinsurers or percentage shares year to year, we cannot roll forward our portfolio year to year or write new guarantees tied to old problems.

Even if it were possible from a regulatory and accounting perspective to handle the rescheduled obligations, the insurance industry has learned a lesson from the banks and cannot and will not mortgage capital by continuous rescheduling. We are not funding institutions and cannot be expected to operate as banks. As a result of this problem we have already lost a lot of the support and capacity for this business and have retrenched significantly in the type of business we do. We believe we provide an extremely valuable service in facilitating trade and investment, and would like to have the opportunity to pursue some of the new ideas I have written about, but can only do so if some satisfactory solution to this problem is found.