

political risk insurance newsletter

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Political Risk Insurance for Investments in Microfinance: A New Frontier

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Historically, microfinance institutions (MFIs) and their stakeholders have shown a tolerance for the risks of operating in challenging environments as they perform their mission of delivering financial services to poor or low-income clients excluded from the mainstream financial system. Some of the risks associated with microfinance are arguably mitigated by the resilience and sound credit quality of the underlying assets – microloans to the working poor. However, as balance sheets of the MFIs have grown, and as events have demonstrated the vulnerabilities of the sector, the importance of a

more robust risk management approach has been brought into focus. The microfinance sector's growing reliance on private capital is likely to bring increasing attention to the risks that MFIs are exposed to and the means of managing them.

What would it take for mainstream investors to fully embrace microfinance as an asset class? Can political risk insurance (PRI) play a role in improving the risk profile of microfinance investments so that more investors can buy into this asset class? The microfinance industry has shown a significant ca-

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An Interview with Lorin (Laddy) Weisenfeld: The Mediation Alternative

Lorin (Laddy) Weisenfeld heads the Washington office of *Felsberg e Associados*, a leading Brazilian corporate law firm based in São Paulo. The firm handles a variety of trade and investment matters out of its Washington office. Mr. Weisenfeld's practice concentrates on the structuring of investments overseas, financial workouts, and the resolution of investment disputes. We asked Mr. Weisenfeld about his experience and observations with respect to investment conflict mediation.

Q1: In a nutshell, what does a mediator of international investment disputes do?

A mediator is a disinterested facilitator who seeks to guide the parties involved in an investment dispute to an amicable resolution of their differences. Mediation is non-binding and it is typically informal. Mediation is generally contrasted with arbitration, which involves a formal and adversarial adjudicatory proceeding and whose results are binding on the parties and enforceable against them.

Q2: What does it take to be a successful mediator of investment disputes?

Legal training and corporate law experience is a strong plus. Most investment disputes arise because of a disagreement over legal issues, and even essentially political issues come down fairly quickly to questions of contractual interpretation, local law provisions, or international law requirements. Experience with contract law, administrative law, and the rules of evidence make it easier for the mediator to grapple with the issues and to resist the pettifoggery of often aggressive counsel for the parties. Business experience, and subject

knowledge relevant to the case, are also very helpful.

The most important personal qualities of a mediator are maturity, impartiality and the right blend of persistence and patience. Cultural sensitivity and linguistic skills are also very beneficial.

Q3: How did you happen to become a mediator in this field?

In truth, I fell into it, probably because I had lived abroad – I studied in France and I later taught law school in Costa Rica under the Fulbright program – before I began my legal career. That was at a time when overseas experiences were not common for young lawyers. When I began to practice law, I was given assignments that drew on this background, if only because I could understand the languages in which the problems arose and could read applicable foreign legislation without needing to drag in an interpreter. When things went wrong, as they sometimes do in complex transactions with overseas components, I was given an opportunity to help put the transactions back on track. I found this work congenial, and over time I gained confidence in my ability to resolve problems arising in legal cultures different from our own. Then, at the Multilateral Investment Guarantee Agency (MIGA), the investment insurance arm of the World Bank, I gained invaluable experience directing its mediation service for over a decade. I now apply that experience to investment mediation in private practice.

Q4: Why do parties to an investment conflict choose mediation?

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The Political Risk Insurance Market and the Current Crisis

by **Charles Berry**

Charles Berry is Chairman of BPL Global and co-founder of the London-based brokerage, Berry, Palmer and Lyle. He is a widely-recognized authority on trade credit and political risk insurance.

Is there any financial market currently not in turmoil?

Yes. There is one at least that is functioning properly, and that is the property/casualty insurance market. In particular, the specialist insurance market for large and complex risks, of which the Political Risk Insurance market forms a small part, is in good health.

It was not always so. The long term liability crisis and the overheated excess of loss reinsurance market in London in the early 1990s (the LMX spiral, as it came to be known) nearly toppled Lloyd's, a lynchpin of the specialist insurance market centred in London. Though Lloyd's problems of the time were only a little local difficulty compared to the current credit crunch, I am not the first to compare the LMX spiral to the current banking crisis.

The comparison starts with the excess of loss reinsurance market's layering or tranching of risk, with the original insurer retaining the first loss, and passing the higher, less risky tranches to others. Having built up a sound track record of profitability, the LMX market attracted too much capital in the late 1980s and overheated. As a result trading became more important than origination for many Lloyd's syndicates: the structure of their reinsurance program became more important than the quality of the risks they wrote; and loss of underwriting discipline at the origination end of the business caused the market to take on portfolios of toxic, under-priced risk. The Piper Alpha disaster in the North Sea was only the first of the major losses that exposed the damage that the LMX spiral had wrought. A USD 1 billion loss to the policyholders translated into USD 40 billion of paid claims within the London market as the loss ricocheted around the spiral. The losers in this game of pass the parcel were the Lloyd's syndicates that ran out of reinsurance first.

If only AIG had stayed with its well-managed and exceptionally strong property/casualty insurance businesses and not wandered far, far too deep into the casino of collateralized debt obligations and credit default swaps, it would not be in its current, truly historic mess.

The over exuberant LMX spiral (which had appeared to have introduced a new market paradigm) only served to remind the London insurance market of some fundamental truths: namely, that an overheated secondary trading market produces a mentality that undermines origination discipline; and that no amount of trading can rid a financial system of the toxic assets that are introduced into the market as a result. Sub-prime holds the same message for the banking market.

The Lloyd's crisis was eventually worked through, at a huge cost to

many of Lloyd's backers (about 4,000 personal bankruptcies), the passage of time, and a degree of mutualisation around the market (but without tax payers money). However it is precisely because Lloyd's and the London insurance market recently had this near death experience that the market's fundamentals are today arguably stronger than they have been in living memory. This is illustrated by Lloyd's recent results. 2008 was the third worst year on record for catastrophe insurance losses, but Lloyd's posted a profit of £1.9 billion, on a combined ratio of 91.3%.

The insurance market still has its problems of course: the insurance industry cycle is not dead; the market has had to weather major losses from 9/11, Katrina, and then Ike and a run of other catastrophes in 2008. Now the market faces significant (but manageable) losses under liability policies in the wake of the credit crisis, an event that will also impact to some extent the assets side of the insurers' balance sheets (though illustrating the conservative bent in insurers investment strategies, Lloyd's made a positive investment return in 2008). So will today's property/casualty insurance market require a systematic government bail out? Absolutely not.

But what about AIG? In reality, AIG perfectly reflects the current contrast between the insurance and banking industry: in the last 15 years the insurance industry has stabilised around fundamental principles, such as underwriting for profit through the cycle and improved risk management; in contrast the banking industry has abandoned sound lending, and embraced a culture that believed that there is no such thing as a bad loan so long as you could trade it away. If only AIG had stayed with its well-managed and exceptionally strong property/casualty insurance businesses and not wandered far, far too deep into the casino of collateralized debt obligations and credit default swaps, it would not be in its current, truly historic mess. The sooner AIG's sound property/casualty insurance businesses are surgically removed from the smoking wreckage of the group and re-branded, the happier we shall be.

The PRI market accounts for maybe only 1 or 2 percent of the activity of this specialist property/casualty insurance market. The credit crisis and the global slowdown brings us both challenges and opportunities in equal measure. The picture is slightly different within the PRI market's two main categories of cover: emerging market non-payment insurance covering default by both government and, to an increasing extent these days, private obligors; and the "pure" political risks activities that cover assets and investments in emerging markets against expropriation, political violence and similar risks.

On the non-payment side, the PRI market has followed a generally cautious and selective approach to underwriting emerging market credit risk. Even so, the current crisis will provide the market with a major test. We are already seeing a marked increase in the number of workouts, potential claims and actual claims in the market.

However, I am confident that the PRI market will emerge from this crisis with a validated non-payment insurance product, and a validated underwriting approach for emerging market credit risks. Hec-

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The Political Risk Insurance Market and the Current Crisis (cont'd.)

tor Sants, CEO of the UK's Financial Services Authority (FSA) recently commented that bankers need to revert to traditional virtues, like understanding their customers' businesses and assessing risk in the expectation that they will hold loans to maturity. Had he mentioned that they should focus their lending on supporting trade transactions in the real economy, he would have mentioned all three of the fundamental principles that, on the whole, have guided the PRI market's selective approach to underwriting emerging market credit risk. I expect this approach will ultimately stand the PRI market in good stead.

Meanwhile for those insurers who have kept some of their powder dry, the current challenging environment presents interesting opportunities. Even in a major downturn, significant quantities of commodities and goods continue to flow around the world. We expect the non-payment insurance product mix to change, but we expect that the PRI market will continue to play a significant role in supporting trade finance and trade and commodity flows into and out of emerging markets.

Turning to the "pure" political risk coverage of expropriation, political violence and the like, we believe that the current crisis has significantly increased demand for these products.

The events of September and October 2008 have jolted the business community into a more realistic assessment of the political risks present in emerging markets.

... it has taken, in our view, the shocks of the autumn of 2008 to remove the rose tinted spectacles through which corporations and financial institutions have been viewing the risks associated with their assets, investments and loans in emerging markets.

In the 1990s businesses adopted a benign view of the world. The collapse of the Berlin Wall seemed to promise a new era of peace and stability and a new world order based on the rule of law. The spread of democracy and free market principles around the world would surely usher in a new era of globalisation. In a memorable phrase, it was the end of History. The West had won: why buy PRI?

It has been abundantly clear for some time to PRI market professionals that this vision of the 1990s was not being realised. The increased economic and political power of the BRIC countries; global terrorism; resource nationalism; global warming; and now the economic crisis: all point to a new era of instability and disorder in emerging markets. Indeed we may well now have more history in front of us than behind us. Yet it has taken, in our view, the shocks of the autumn of 2008 to remove the rose tinted spectacles through which corporations and financial institutions have been viewing the risks associated with their assets, investments and loans in emerging markets.

This new realism is causing many of our clients to look again at what the PRI market has to offer. They are seeing a product offer-

ing very different from that of ten or even five years ago. For the PRI market has been through a significant phase of product development in the last few years. We have in effect reinvented the market for "war risks" on land; in addition we have re-engineered the more traditional investment insurance coverage.

In the property insurance market "war risks" encompasses all political risk perils, starting these days with terrorism, and moving through riot and civil commotion, to insurrection and rebellion, to war and civil war, and including also confiscation. Indeed confiscation, capture and seizure are arguably the main "war risk" perils from a historical point of view. So the "war risk" policies now available from the PRI market for land-based assets provide indemnity for loss or damage to tangible property, and resulting business interruption, due to a wide spectrum of political violence and political risk perils. PRI in a property insurance form, in other words, rather than an equity or lenders form.

The re-emergence of this type of cover for land based property builds on the long "war risks" insurance traditions of the London insurance market, but puts to an end the long period since the mid-1930s when these types of war risk covers were only available for ships and aircraft. It is a far simpler approach to political risk coverage than the traditional, more sophisticated, investment insurance type products. But this simplicity is part of the attraction. Furthermore, we have a very clear message for the risk management community: this type of "war risks" insurance from the PRI market is the only source of political violence coverage that adequately addresses the spectrum of political violence that is commonplace in emerging markets today. This element of the PRI market's product portfolio is therefore essential – not optional – cover for tangible property in emerging markets. And the importance of carrying this type of broad form political violence cover will increase: as the economic crisis bites in emerging markets, political violence of all types will escalate.

... it has become important for policies to address the question of when international arbitration between investor and host government should be seen as a recovery mechanism for insurers after claims payment, and when it should be seen as a necessary prerequisite for the policyholder to establish that they have a valid claim.

For those who still want to embrace the broader, more complex equity and lenders' forms of investment insurance, they will find that the market offers today a re-engineered product, that goes well beyond the "Expropriation" centred policy, that was standard fare until a few years ago.

While expropriation remains an important element of the risk, today's policies are more roundly focused on an investor's rights. Where clients of the market have perhaps found the expropriation cover wanting in the past, a common thread is that while expropriation may well be a breach of an investor's rights, a breach of their

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The Political Risk Insurance Market and the Current Crisis (cont'd.)

rights is not necessarily an expropriation.

This new focus on the broader rights of an investor has benefited from a changing legal framework for FDI. Though far from complete, the improved network of bilateral and multilateral investment treaties (BITs and MITs) provides a better backdrop for investment insurers to go beyond expropriation cover and address the other rights that investors enjoy in emerging markets. Additionally, the market has become keenly aware that investment insurance claims these days may well take place against a backdrop of international arbitration between investor and host government. It has become necessary to integrate this improved legal environment with the operation of investment insurance policies. In particular, it has become important for policies to address the question of when international arbitration between investor and host government should be seen as a recovery mechanism for insurers after claims payment,

and when it should be seen as a necessary pre-requisite for the policyholder to establish that they have a valid claim.

With an improved, broader and better crafted product offering, and with a fresh interest in political risk insurance from clients engaged in emerging markets, we see the current crisis providing considerable opportunities for growth in our activities in the pure political risk area. More generally, while the PRI market certainly has challenges arising from the current crisis, particularly in its book of emerging market credit risks, the market will weather the storm. Like the general insurance market for specialist property / casualty risks of which it forms a small part, the fundamentals of the PRI market are sound, the market is functioning properly, and the market continues to innovate in response to changing client demand in a more challenging global environment. ■

MARKET PROFILE:



For more than 125 years, the Chubb Group of Insurance Companies has been delivering exceptional property and casualty insurance products

and services to business and individuals around the world. Today, Chubb ranks as one of the largest property and casualty insurer in the United States and has a worldwide network of some 120 offices in 28 countries staffed by 10,600 employees. The Chubb Corporation reported \$50.6 billion in assets and \$14.1 billion in revenues in 2007. According to *Fortune* magazine, Chubb is the 176th largest US-based corporation. The magazine also includes Chubb in its list of "America's Most Admired Companies." *Forbes* listed Chubb as one of America's 400 Best Big Companies.

Chubb's success has not been based on size or longevity. The company consistently ranks as one of the best insurance service providers around the world. The company also enjoys a long history of consistently high financial ratings. Chubb focuses on niche specialty coverages and excels in providing excellent service in those specialties. Two of those specialty coverages are Political Risk and medium-term Structured Trade Credit insurance.

Products and Coverages:

Expropriatory Conduct (CEN): Confiscation, Expropriation, Nationalization, et al.; Currently Inconvertibility and Transfer Risk; Political Violence and War.

Contract Frustration: Sovereign and Sub-sovereign Non-Payment; Embargo; War; Unilateral Termination; License Cancellation; Arbitration Award Default; Wrongful Calling of Guarantees.

Structured Trade Credit: Private Buyer Non-Payment.

Underwriting Capacities: Expropriatory Conduct and Contract Frustration: Up to \$75 million per transaction for a period of up to 10 years.

Structured Trade Credit: Up to \$25 million per transaction for a period of up to 5 years.

Financial Ratings: The member insurers of the Chubb Group of Insurance Companies consistently earn high financial ratings.

S&P:	AA	MOODY'S:	Aa2
FITCH:	AA	AM BEST:	A++

Locations and Key People:

Whitehouse Station, New Jersey, USA: Keith M. Dunford – VP and Worldwide Underwriting Manager & Basil Louvaris – AVP and Manager North America

London, United Kingdom: Simon Hayter – VP and Manager Europe, Hubert Belanger – VP and Manager Continental Europe & Richard Byles – Manager Structured Trade Credit

Singapore: Kyle Williams – VP and Manager Asia/Pacific, Sydney, NSW, Australia & Ann Russell-Cook – AVP and Manager Australia and Japan

Company Comment: Chubb Political Risk initiated underwriting in April of 1997. Since then, the operation has grown to four offices underwriting political risk in every major market in the world. During the past eleven years Chubb Political Risk has expanded its staff to include ten underwriting professionals who possess a total of more than 145 years of underwriting experience. The total business portfolio includes political risk exposures in 104 emerging markets.

In addition, Chubb has had the opportunity to help numerous insureds in difficult claim situations that were ultimately amicably resolved. Chubb has also paid PRI claims to insureds for losses in various countries, including China, Nigeria, Zambia, Lebanon, Tajikistan and the Dominican Republic.

In April of 2007 Chubb expanded its capabilities and initiated underwriting medium-term structured trade credit transactions.

Contact Information: For Political Risk and Structured Trade Credit inquiries, please contact Mr. Basil Louvaris in New Jersey at (908) 903-3442. ■

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capacity for innovation. Political risk underwriters have similarly demonstrated an ability to respond to changing marketplace needs and opportunities. The time appears ripe for a productive conversation between microfinance investors and political risk insurers to better unlock funding for this dynamic market.

The commercialization and scaling-up of microfinance

Over the past 30 years, microfinance has proven to be an effective way to promote economic and social development by providing inclusive financial services for the working poor. What started as a few philanthropic projects in Bolivia, Bangladesh and other countries in the early 1970s is now an estimated US \$35 billion industry comprised of some 10,000 MFIs which provide a wide range of financial services, including credit, savings, remittances, payment services, and health and life insurance to more than 150 million clients worldwide. While these numbers are growing rapidly, they pale in comparison to the sector's potential. According to Standard & Poor's (S&P), there are about 1.5 billion poor people who are potentially eligible for loans or other microfinance services, representing a total potential market of more than US \$300 billion. While there are many small microfinance operations, the majority of microfinance borrowers and assets are concentrated in approximately 150 leading or "top-tier" MFIs.

Over the past decade, the microfinance industry has been transforming from donor-funded development projects managed by international NGOs to commercially viable and often locally regulated financial institutions, with international capital markets an increasingly important source of financing for the industry's growth.

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Two primary categories of players have emerged in leading the flow of commercial funds to microfinance: international financial institutions (IFIs) and development finance institutions (DFIs), as well as microfinance investment vehicles (MIVs) that attract funds in large measure from socially responsible investors, a growing contingent of private sector investments. According to the Consultative Group to Assist the Poor (CGAP), a leading policy and research centre dedicated to advancing financial access for the world's poor through microfinance, investments in microfinance by international public and private sector investors more than tripled between 2004 and 2007, totaling US \$6.7 billion in 2007. Market participants forecast a further increase in microfinance investments of around US \$20 billion by 2015. There are more than 90 MIVs, half of which have been created during the past five years. Moreover, as reported by Credit Suisse, total investments by institutional and individual investors (US \$3.7 billion) exceeded total investments by IFIs and DFIs (US \$3 billion) for the first time in 2007. According to Symbiotics (a Swiss investment brokerage firm) in Luxembourg alone, a popular domicile for MIVs, there were 21 MIVs as of December 31, 2008, boasting total assets of US \$2.38 billion (a staggering growth of 800 percent since

December 2005). Clearly, scale has arrived in microfinance funding.

Recently, in response to the global financial crisis and refinancing challenges experienced by MFIs, IFIs led the way in establishing the Microfinance Enhancement Facility, a short- to medium-term fund of up to US \$500 million, with initial contributions of US \$150 million from IFC and US \$130 million from KfW. The facility is expected to provide funding to up to 200 MFIs, in up to 40 countries, including 20 of the world's poorest countries.

While the global financial crisis has made some commercial lenders more cautious... commercial investors have exhibited an abundant appetite for equity investments in microfinance.

On the commercial banking front, major players have entered the market, underwriting and investing in deals for the microfinance sector, including Deutsche Bank, Morgan Stanley, Citi, Credit Suisse, Standard Chartered, JP Morgan and HSBC, as well as emerging markets private equity investors such as Sequoia, Blackstone, Carlyle and others. And no wonder. The credit risk associated with microfinance projects is relatively small. According to Deutsche Bank, MFIs historically reported repayment rates exceeding 97 percent. And the industry is reliably reported to enjoy returns on assets of 3 to 5 percent and returns on equity of 20 to 30 percent. At a time when most of traditional asset classes demonstrate negative returns, microfinance is showing resilience and positive returns.

While the global financial crisis has made some commercial lenders more cautious, and many MFIs have had difficulty raising capital in 2008, commercial investors have exhibited an abundant appetite for equity investments in microfinance. For example, Developing World Markets has recently closed its DWM Microfinance Equity Fund I with a commitment of US \$82 million from four large institutional investors, including two large pension funds: Netherlands-based APG (All Pension Group), a European pension asset manager, and New York-based TIAA-CREF. According to a recent study by JP Morgan and CGAP, by the end of 2008, there were 24 specialized equity funds dedicated to microfinance, totaling US \$1.5 billion under management.

The microfinance industry and its investment bankers (Deutsche Bank, Developing World Markets, BlueOrchard and Symbiotics among others) are demonstrating an increasing sophistication in structuring capital markets transactions as a means to mobilize large sums of capital. Over the past five years, the microfinance industry has seen groundbreaking capital markets transactions, including bonds, securitizations and IPOs.

According to S&P's earlier estimates, securitization volumes in microfinance could reach between US \$1 billion-\$3 billion annually over the next decade. Because of the impact of unrelated sub-

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prime mortgage collateralized debt obligations (CDOs), the microfinance CDO market has been quiet since the landmark US \$110 million microfinance collateralized loan obligation (CLO) arranged by BlueOrchard and Morgan Stanley and rated by S&P in May of 2007. Microfinance CLOs are poised for return in force when market conditions improve.

Nevertheless, the industry is vulnerable to the current credit crisis, with rising borrowing costs, shortening maturities and heightened lender sensitivity to risk, including foreign exchange risk. While funding from IFIs and DFIs is likely to remain stable and even grow in response to the crisis, foreign aid budgets are under pressure, some previously active banks are withdrawing from the microfinance business, and refinancing of existing debt is becoming a pressing concern for MFIs.

Microfinance is no stranger to political risks

The global financial turmoil also means that MFIs will face increasing risks as a result of the deteriorating political environment in some of the countries in which they operate. The industry has already seen a number of clashes between MFIs and governments that resulted in losses to MFIs or their complete closure. According to Microfinance Information eXchange, 2006 was a crisis year for MFIs in Uzbekistan (notably those affiliated with foreign international NGOs, which accounted for over 50 percent of the total microfinance portfolio in the country), when the government enacted new laws to regulate the operation of non-bank lending institutions. These laws required MFIs that were operating as NGOs to restructure into for-profit entities, which is normally a fairly involved process, or face penalties or forced closure. However, no grace period was provided for MFIs to do so and no clear procedures were set for registering under the new laws. Concurrently, the government pursued tax audits of several MFIs. In the end, three of the US-affiliated institutions were forced to close down their operations as a result of crippling back-taxes and penalties imposed by the government. Most of the other MFIs had to suspend their lending operations for more than six months until new procedures for registration under the new statutory structure were adopted.

The industry has already seen a number of clashes between MFIs and governments that resulted in losses to MFIs or their complete closure.

Populist governments have also cracked down on MFIs in Ecuador, Nicaragua and India. *The Economist* reported on the most notorious of these cases, which took place in India in 2006, where local government officials in the state of Andhra Pradesh shut down 50 branch offices of four MFIs, imprisoned their loan officers, seized and destroyed their records and encouraged clients not to repay their loans. This controversial dispute lasted for about six months, resulting in MFIs' agreement with the provincial government to cap interest rates. Such conflicts could emerge in other countries due to competition between state-run and private MFIs, and for other political reasons.

Microfinance operations also appear to be particularly vulnerable to episodes of political violence, with civil wars, cross-border conflicts and local disturbances causing the interruption or termination of operations and/or the destruction of assets in such places as Liberia, Eritrea, Bosnia, Nepal, Sri Lanka and Bolivia. The recent military confrontation in Georgia did not have a lasting negative impact on MFIs and their portfolios in the affected regions, but it certainly served as a reminder of political and security vulnerabilities in the Caucasus. And currency transfer delays or blockages, such as investors of all categories have encountered in places like Argentina and Venezuela in recent years, strike all sectors, microfinance not excluded.

These kinds of loss events that MFIs have suffered are precisely those that political risk insurers are prepared to deal with.

PRI to the rescue?

So far, public sector political risk insurers have taken the initiative in recognizing and responding to the microfinance sector's coverage needs. The Overseas Private Investment Corporation (OPIC) is developing coverage that includes, in addition to traditional expropriation, political violence and currency inconvertibility protection, coverage against sovereign imposition of interest rate caps and business interruption coverage against losses arising from political violence-caused defaults by downstream borrowers. OPIC is also working on a master policy form geared to MIV exposures to global microfinance operations.

PRI has played an important role in facilitating increased capital flows to emerging markets in sectors comparable to microfinance: commercial banking, financial services and capital markets.

The Multilateral Investment Guarantee Agency (MIGA) has not tailored products for microfinance investments, but it has provided coverage to a number of relatively small microfinance transactions. Export Development Canada (EDC) provided tailored political risk coverage to Développement international Desjardins (DID), a global leader in microfinance consulting and technical services. The policy extended expropriation, political violence, and currency inconvertibility coverage for DID assets in 21 emerging countries, including several high-risk markets.

Private political risk insurers have tended to view the sector as involving transactions too small to merit their attention. Certainly, many microfinance investors would not offer exposures of a size that would interest private political risk insurers. But with the increasing scale of investment activities per country and worldwide (through ordinary growth or consolidation) and the large sums they are moving cross-border, there should be attractive opportunities for political risk insurers. Global policies for MIVs and MFI networks or holding companies with substantial worldwide exposures would

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yield lower premium unit costs for those investors and provide economies of scale and spread of risk for underwriters.

Public agencies may offer lower cost protection and possibly more generous conditions, but microfinance investors who intend to approach public agency underwriters like OPIC and MIGA need to be alert to their policy criteria and, in particular, their mandate to underwrite new but not existing exposures. MIVs and other lenders to MFIs may find that private insurers will have greater flexibility and freedom from eligibility and other constraining policy criteria. In any case, the growth and potential size of the market should provide ample opportunities for both public and private insurers.

In addition to encouraging equity investment in MFIs, the coverages offered by political risk insurers ... can be used to protect senior lenders and to encourage them to offer longer tenors as well as achieve higher credit ratings for structured capital markets transactions.

Political risk insurers, once convinced of the opportunities, have shown an admirable capacity to create products and coverage terms tailored to a variety of sectors, instruments, and needs. Some years past, few would have anticipated that the market would have well-fashioned policies for capital markets issues, coverages that dealt with the special circumstances of project financing, regulated industries, and oil production sharing agreements, or non-honoring coverage that would respond to Basel II compliance issues. In all instances, the PRI market provided tailored coverages that were instrumental in managing political risks and in augmenting the flow of funds to which those risks were an obstacle. For investors, the key to obtaining the proper protection is to recognize that PRI is not traditional insurance but a financial instrument for managing risks that requires both expert financial, legal and insurance assistance as well as the close attention of company management.

PRI has played an important role in facilitating increased capital flows to emerging markets in sectors comparable to microfinance: commercial banking, financial services and capital markets. For example, in 2007, MIGA issued US \$10.2 million in coverage to the First Kazakh Securitization Company, B.V. for a securitization of residential mortgage loans in Kazakhstan. MIGA covered a portion of interest payments on the mortgage portfolio against transfer and convertibility restrictions and expropriation. MIGA's coverage was instrumental in securing an increase in Fitch's rating for the \$141 million transaction to A- (above the country ceiling of BBB+).

In addition to encouraging equity investment in MFIs, the coverages offered by political risk insurers (currency inconvertibility, political violence and expropriation, including arbitral award defaults) can be used to protect senior lenders and to encourage them to offer longer tenors as well as achieve higher credit ratings for structured capital markets transactions.

There is ample precedent for believing that the right approach by microfinance investors will elicit from political risk insurers a product

that deals effectively with the sector's risks and that will lead to enhanced investment flows to the sector.

Whether coverage is sought from public or private insurers, the usual sound practices apply: a timely approach to the marketplace, a focus first on getting the best coverage rather than the (apparently) cheapest, a careful and complete laying out of the facts to the underwriter and well-advised negotiations to achieve the optimal and most appropriate coverage for the transaction(s) in question. As MFIs tend to grow, consolidate, graduate to more regulated status within the countries in which they operate and offer a greater diversity of financial products, it would be desirable for microfinance investors and lenders to anticipate those changes and to seek coverage flexible enough to keep pace with their evolving circumstances. Above all, investors in this sector need to reflect on the special political risks and concerns that confront them, and to work with their specialist advisers to see that their coverage is duly designed to address those matters. *[Readers may wish to refer to our article in the September 2008 issue of this Newsletter, "Making a Claim: Readiness is All" for detailed suggestions regarding obtaining and maintaining PRI that will respond effectively to losses when they occur.]*

The microfinance industry has funding needs that the marketplace may be willing to satisfy only if the risks can be rendered manageable. Political risk insurance has the capacity to help manage some of the most critical of those risks. It is time for the conversation between microfinance investors and political risk insurers to begin in earnest. ■



Tatyana A. Mikhailova, a co-author of this article, is an attorney whose practice focuses on cross-border structured finance transactions, political risk insurance, microfinance and international arbitration. Prior to joining Robert Wray PLLC, Ms. Mikhailova served as in-house counsel with a major Washington DC-based microfinance organization with operations in 23 countries. Her microfinance experience includes conducting legal feasibility studies for, and advising on, asset acquisition, greenfield projects, and transformations of

non-profit entities into locally regulated banking and financial institutions in Eurasia. She has advised MFIs in negotiating numerous financing facilities with commercial and multinational lenders and also acted as legal counsel in complex litigation and expropriation matters.

The Microfinance practice at Robert Wray PLLC is led by Ms. Mikhailova, Robert T. Wray, Felton (Mac) Johnston, and Geraldine R.S. Mataka. The RW microfinance team provides legal and related services in the areas of debt and equity financing, structured finance, transformation into regulated financial institutions, consolidation, litigation and arbitration. In its Political Risk Insurance practice the firm offers expert assistance to investors in connection with the negotiation of coverage, evaluation of coverage effectiveness, the pursuit of claims, and arbitration of disputed claims.

An Interview with Laddy Weisenfeld: The Mediation Alternative (cont'd.)

Almost invariably, the motivation is to find a negotiated basis for a settlement of the dispute before matters get out of hand, positions become more entrenched, or the dispute becomes overly politicized. The impetus to seek a mediated resolution of a pending investment dispute can come from either of the two parties to the conflict or from an interested third party, such as the host government of the investor, a lender to the project, or an international development agency whose program is affected by the dispute.

Sadly, mediation of investment disputes is still not a well known course of action, even in sophisticated investment circles. I have seen a number of disputes that probably could have been resolved through mediation go on to arbitration because the parties were not aware of the availability of mediation.

Even when one party announces that it would like to attempt mediation, the proposal is often a hard sell. That party, which more often than not is the foreign investor, generally needs to make a concerted effort to persuade the host government to agree to participate in mediation.

Q5: Why is that? Is there a downside to mediation?

No. Generally there is no risk in agreeing to mediate. Rather, because the institution of mediation is so little known, there is a hesitancy to embark into uncharted waters. Governments, in particular, find it difficult to take a new course when faced with an investment dispute. If disputes in the past always went to arbitration, then a minister might be hesitant today to suggest an alternative — even if his government always lost in arbitration.

Q6: How well does investment conflict mediation work and what are the ingredients of a successful mediation?

Mediation has a better than even chance, in my experience, of

resolving an investment dispute. Perhaps two-thirds of the investment disputes that I have been asked to work on have been resolved through mediation. But that resolution doesn't come easily or quickly. It generally takes a minimum of a year and often two years for the dispute to be resolved. Still, it is worth noting that mediation is generally more expeditious than arbitration and infinitely less expensive. Mediation becomes more difficult when the matter is highly politicized or involves very large sums, if it significantly affects third parties in the capital-importing state, or if the parties are of greatly differing size, economic power, or leverage. Those things aside, reasonableness and good faith are key. Each party has to want to resolve the conflict and has to make the effort to reach a settlement, which is to say to compromise. And a capable mediator must be there to encourage that outcome. Evidence has to be adduced, allegations answered, and losses fairly calculated. Neither side can expect to prevail entirely. It is often said that the definition of a successful mediation is a solution that leaves neither party terribly happy but not so unhappy as to want to continue the dispute.

More and more investment agreements are now requiring that recourse be first to mediation before arbitration is commenced.

Q7: When is the right time to choose mediation?

More and more investment agreements are now requiring that recourse be first to mediation before arbitration is commenced. That makes sense to me, and it need not entail a loss of time because the agreement can specify that arbitration can begin if mediation hasn't been completed within a specified period. Or mediation can proceed contemporaneously with arbitration. The mediation process may reveal to the parties the relative strength of their positions and the merits of seeking a resolution short of the costly, time-consuming and unpredictable arbitration process. ■

about this newsletter

Our intention is to provide a forum for the exchange of information and opinions relating to topics that will be of interest to political risk insurers, buyers, brokers, attorneys and others. We invite contributions and suggestions from professionals in the field.

We also encourage readers to submit information about notable transactions, personnel changes and other important developments in the political risk insurance sector.

If you would like to receive future editions of the PRI Newsletter electronically, or if you have friends or colleagues who would be interested in joining our distribution list, please e-mail us at info@robertwraypllc.com. This and previous editions of the newsletter are available at www.robertwraypllc.com

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about robert wray PLLC

robert wray PLLC is a specialized law firm focused on analyzing complex issues and providing innovative solutions in the areas of political risk insurance, project finance, transportation infrastructure, privatization, aircraft finance, microfinance and international arbitration. The firm's political risk insurance practice, led by Robert T. Wray and Felton (Mac) Johnston, offers comprehensive advice related to the mitigation of risks and selection and acquisition of political risk insurance associated with international investments.

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