

# INDIA'S POLITICAL RISK INSURANCE INDUSTRY



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Indian companies are concertedly stepping up their global presence. Among other things, they have boosted their overseas investment from US\$0.7 billion in 2000 to US\$11 billion in 2006. It is likely that they will invest over US\$15 billion outward in 2007-2008, more than foreign companies are projected to invest in India over the same period.<sup>1</sup>

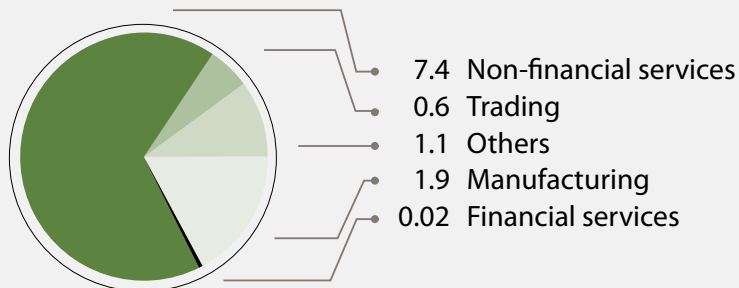
A growing global presence brings the danger of a greater exposure to political risk. In this context, how are India's new globalisers approaching the issue of political risk in the markets in which they are investing? To what extent are these perceptions – together with the availability of suitable risk insurance products – determining where they are choosing to invest? Most importantly, how is the current surge in outward investment impacting India's political risk insurance industry?

To begin to answer these questions, five Indian multinational enterprises were interviewed. This sample of companies included some of India's top 'globalisers', namely, Tata Steel, NIIT (a global IT learning solutions corporation) and Ranbaxy Laboratories Ltd. (pharmaceuticals), as well as two recent outward investors, SRF (technical textiles, refrigerant gases) and DCM Sriram Consolidated Limited (DSCIL) (chloro-vinyl and agribusiness). Also interviewed were India's political risk insurance provider, the Export Credit Guarantee Corporation, and three general insurers, namely, Bajaj Allianz, IFFCO-Tokio General Insurance Co. Ltd. and New India Assurance.

## How do Indian multinationals perceive overseas political risk?

Apart from Tata Steel, none of the companies interviewed have purchased political risk insurance. Tata Steel is currently in the process of implementing a US\$100 million ferro-chrome project in South Africa, for which it has been required – as are all foreign direct investors in the country – to buy the civil disturbance and terror cover provided by the South African Special Risks Insurance Association.

## India's Outward Investments (2006-2007): Sectoral Composition (US\$ billion)



Source: Reserve Bank of India Annual Report 2006-2007

While some of the executives interviewed were unfamiliar with the concept of political risk insurance, others had not considered it necessary. They all perceive the world to be a politically safer place for foreign investors. Says Rajendra Prasad, Chief Financial Officer, SRF – a leading Indian refrigerant gas producer: “Developing countries develop not only economically but politically as well. They are unlikely to act arbitrarily against foreign investments, now globally accepted as a force for development.”

Thus, while Indian companies do see terrorism intensifying over the next few years, they do not perceive expropriation and transfer of payments (remittance) restrictions to be a danger any longer. More generally, the executives interviewed argued that Indian companies have a far higher risk tolerance than firms based in industrialized countries, in light of the relatively greater political and economic uncertainty in India.

Also, these companies have been investing primarily in developed countries, where political risk is negligible. Their experience mirrors the pattern seen in India’s recent surge in FDI outflows; over 90% of which is flowing to industrialized countries. The bulk of Tata Steel’s overseas investment, for instance, has been the US\$12 billion purchase of the British-Dutch steel giant, Corus. Ranbaxy and NIIT are investing mostly in the United States, but are also locating in other developed and emerging markets with relatively low perceived political risk.

Sectorally, two-thirds of India’s total outward investment of US\$11 billion in 2006-07 was in non-financial services.

Further, Indian companies are investing overseas primarily through the take-over of existing firms, rather than through greenfield investments. Of the over 300 overseas investments that Indian companies have made since 2000, mergers and acquisitions have almost quintupled – from 37 in 2001 to 170 in 2006. But even those companies that are putting their money into developing countries – such as SRF with a chemical manufacturing joint venture in China and DSCL with hybrid seeds operations in the Philippines,

Vietnam and Thailand – do not feel a strong need to insure themselves. As the executives interviewed explained, since these overseas acquisitions have operated successfully for years, they perceived them to be sufficiently ‘risk-tested’ and not requiring further political risk insurance.

More generally, India’s outward investors – with a handful of exceptions – are investing in their own subsidiaries and associated overseas entities, through loans from Indian and international financial institutions.

What worries India’s new ‘globalisers’ the most is the risk of a sudden policy change, both in India and overseas. As Vijay Thadani, Chief Executive Officer of NIIT, stressed, “If there were some sort of insurance against the policy fallout of political regime change,

whether at a national or state level, we would definitely be interested.” The company had to write off US\$5 million in Malaysia, following a sudden shift in the licensing of IT education centres after the exit of former Prime Minister Mahathir bin Mohamad. Indian IT services companies are especially concerned, he continued, about the risk of unexpected reversals in United States’ policies on outsourcing and off-shoring.

Thus, these companies have not felt the need to develop systematic political risk assessment parameters when considering foreign direct investment ventures, although they have fairly detailed processes by which they examine commercial and business risk. NIIT’s process is especially detailed. Not only does it thoroughly evaluate the

## About the Export Credit Guarantee Corporation

ECGC is a government-owned operation, specializing in export insurance. It set up its Overseas Investment Insurance programme in 1980 to support Indian companies venturing offshore via overseas marketing offices, joint ventures, and other kinds of investments. An added objective is to reinforce political ties with key developing countries through boosted outward investment flows.

As yet, short-term export insurance accounts for the largest part of ECGC’s business. In 2006-2007, for example, 94% of its premium income came from short-term policies. Only 4% came from medium- and long-term business, with project and term policies accounting for 3% and overseas investment insurance policies for 1%, respectively, as the table below shows.

### Premium Income – Policies 2006-2007 (in US\$)

Short term	48 million
Project and term export policies	2 million
Factoring	0.47 million
Overseas investment policies	0.59 million
Transfer guarantees	0.005 million

*Commercial risk has accounted for 78% (US\$910 million) and political risk for 18% (US\$210 million) of all ECGC claims to-date.*

target investment's 'business model', it also examines broader host country factors, including its macroeconomic performance, its legal and anti-piracy framework, its talent pool, and vulnerability to terrorism. Tata Steel takes the added step of stationing executives in advance in target markets, particularly those where greenfield investments are being planned.

Going forward, all five companies plan to step up their investments in more risky developing country markets. To this end, they say, they will need to develop more focused political risk assessment parameters and, in some cases, also invest in political risk insurance.

## India's PRI Industry

Since most of India's investors are not yet availing of political risk insurance, this market is still miniscule by global standards. India's hitherto restrictive outward investment regime has also been responsible. For these reasons, the Export Credit Guarantee Corporation (ECGC) – India's sole political risk insurance provider today – has issued just 55 policies worth US\$155 million since it was set up fifty years ago. These investment covers were in respect of two large phosphoric acid plants in Jordan and Morocco. It currently has only 6 policies in force worth US\$76 million.

ECGC did relatively brisk business in the 1980s, issuing 32 policies. Growth thereafter slumped due to investor wariness triggered by the 1991 Gulf War. ECGC issued just 11 policies in the 1990s and 12 policies after 2000. Average policy size, however, has risen dramatically – from US\$200,000 in the 1980s to US\$7 million post-2000. The largest policy issued to-date is the US\$48 million policy to the Indian Oil Corporation in 2003.

The geographic concentration of these policies has also shifted significantly. South-East Asia – Indonesia, in particular – accounted for two-thirds of all ECGC policies in the 1980s, and Nigeria and Kenya for one-sixth. In the 1990s, the Middle East and emerging Europe rose in significance, and so did China post-2000.

## How ECGC Classifies Country Risk

ECGC uses the following 7 weighted parameters to classify risk in 237 countries.

Factor	Weight
Economic risk rating	35
Political risk rating	20
Experience of ECGC	15
Economic and political relations with India	10
Experience of other credit insurers	10
Forecast (new)	10
<b>TOTAL</b>	<b>100</b>

Scores are then totaled and countries divided into 4 risk categories: A (safest), B, C and D (riskiest).

ECGC has revised this model three times since it was developed in 1995 to respond to evolving investor needs, host country realities, and ECGC capabilities. In calculating 'economic risk', ECGC now includes exchange rate fluctuations, and GDP, inflation, and export growth rates. In calculating 'political risk', it now considers the type of government (that is, democracy or dictatorship, coalition versus single party etc).

When evaluating its own country experience, it now considers all ECGC local exposure, its claim-premium ratio, and the incidence of commercial and political claims. It has now also begun to examine other Berne Union members' experience with the country, particularly the number / percentage of transfer delays. Extra weight is given to 'Focus Programme' countries with which the Indian Government wants to bolster political ties'.

In 2006, ECGC graduated a number of countries into lower-risk categories and separated some island groups (including the French Pacific Islands and the French West Isles) into a collection of self-standing countries, each with its own risk rating.

However, ECGC is now examining how it might quantify client and project risk, over and above country risk. Currently, ECGC relies completely on banks to assess these factors, by only covering those investments being financed by a recognised bank.

Developing robust client and project risk assessment parameters will also be a pre-requisite, to bringing new investment and political risk insurance products to market. At the same time, ECGC will have to start incorporating environment and corruption risk into its assessment parameters, as is now common practice internationally.

ECGC has only had to pay out one claim in its entire history – of US\$0.3 million to Usha Martin, a steel wire rope manufacturing company, for an investment in the former Yugoslavia.

The growth of the Overseas Investment Insurance programme

has also been restricted by ECGC's limited capital base (US\$200 million). While ECGC obtains some re-insurance from India's only re-insurer – the government-run General Insurance Company, it is finding it increasingly difficult to raise additional medium-

and long-term re-insurance from the international market.

Partly to address this problem, the Government has set up the National Export Insurance Account to insure long and medium term exporters against commercial and political risk. The account will be operated by ECGC, and in addition to exports it will also specialize in large construction and similar projects, particularly in countries of political interest to India. The Government plans to expand the account to US\$452 million over the next few years.

Although India's hitherto government-controlled insurance market was opened to Indian and international companies in 1999, no private political risk insurance player has yet emerged. As a result, ECGC has a completely open field – and has not yet felt the need to rethink or re-price its existing political risk insurance offering. Currently, ECGC's only competition is corporate 'self-insurance'. However, ECGC may have to expand the scope of risks it covers to keep with international PRI industry changes.

### ECGC's political risk insurance offering

ECGC protects companies against political risks generally covered by all overseas investment insurers – expropriation, war risks and restriction on remittances. ECGC offers covers for a minimum period of one year and a maximum of 15 years. Only new investments funded by equity or loans are eligible for cover. Premiums are determined with a base rate of 1% per annum ECGC has eight points in its criteria each carrying a weight of 0.25% each, subject to a maximum rate of 2.5% per annum. The rates thus vary depending upon the destination of investments and are payable in Indian Rupees.

ECGC will protect investments in any of the 237 countries for which it has rated political risk. It is thus willing to back projects in more markets that international political risk insurance providers might avoid.

While investments are eligible for 100% cover in the first 10 years, this declines by 10% a year to reach

50% in the 15th year. In risky markets, ECGC may start with only 50% coverage and raise it to 90% as the situation improves. Moreover, companies can choose to cover invested equity, retained earnings, and declared dividends up to a maximum of 150% of the original investment value. In all cases, the investment value and coverage is calculated in Indian Rupees, at the exchange rate prevailing on the day the funds were remitted. Policies are not adjusted to keep up with exchange rate fluctuations.

Investors must notify ECGC as soon as they feel that they may need to make a claim, and must submit it within 3 months of the event. Similarly, ECGC is bound to repay a claim within 6 months of the payment of the overseas enterprise. Investors wishing to terminate their policies must give 3 months notice in writing to ECGC.

As India's outward investment grows, there will be greater need to build corporate capacity to assess political overseas risk in a systematic fashion and to raise awareness about the existence of political risk insurance products. To this end, ECGC has signed a MoU with MIGA and India's EXIM Bank to familiarize Indian outward investors with the concept of political risk insurance. There will also be a need to develop products targeting smaller, first-time investors, who are testing offshore waters through minor investments. Currently, smaller investors desist from buying overseas

investment insurance due to its cost and complexity.

### How is India's PRI market likely to develop?

Even as ECGC girds itself to cater to India's new breed of outward investors, other PRI players will begin to emerge in the Indian market over the next few years. A combination of demand and supply-side factors will drive this development, as explained below.

**Risk now on India's corporate governance agenda** – Tightening Indian corporate governance laws have placed the systematic measurement, minimisation, and reporting of risk firmly on India Inc.'s agenda. In 2006, the Securities and Exchange Board of India – India's corporate regulator – ruled that all publicly listed Indian companies are to establish in-house risk assessment teams and process. These must be regularly reviewed by the company Board. More stringent risk evaluation will combine with corporate globalization plans to place political risk and risk mitigation instruments, including a stronger demand for political risk insurance, at the forefront.

**Investors' growing developing country focus** – While India's current wave of investment has focused on industrialized countries, the next wave – which has already begun – is concentrating

### India's general insurance industry: growing rapidly

ECGC is one of 17 players in the Indian non-life insurance industry, whose total premium income was over US\$6 billion in 2006-2007. Of these 12 are general insurance companies – 4 long-standing government insurers (New India Assurance Company Limited, National Insurance Company Limited, United India Insurance Company Limited, and Oriental Insurance Limited), and 8 newly-formed joint ventures between leading Indian banks/firms and international insurers (Bajaj Allianz, Royal Sundaram Alliance, Tata-AIG General, Reliance General, IFFCO-Tokio, ICICI-Lombard, HDFC Chubb, and Cholamandalam MS General Insurance).

on South East Asia, the Middle East, China and Central Asia. Indian companies are now also beginning to look seriously at Africa and Latin America.

Not only are the banks financing these investments likely to require political risk insurance, companies themselves might feel more secure investing in it.

**Burgeoning insurance industry** – On the supply side, India's rapidly growing India's general insurance industry – in particular its fast-growing new private players – will most certainly respond to these developments. Through aggressive marketing and novel product development, these insurers have already grown their share of the general insurance market to over 40% since 2002.

In fact, India's insurance industry,

already the 23rd largest in the world, is estimated to grow to US\$60 billion by 2010, with the non-life segment accounting for US\$25 billion. The lifting of price controls on a range of insurance products is also encouraging insurance firms to explore a variety of new business avenues. While, admittedly, these developments do not relate directly to overseas investment insurance, they will further encourage ECGC and others to respond to potential PRI demand by developing customized products for the Indian outward investor.

Most importantly, the entry of global re-insurance firms into India will dramatically boost the Indian insurance industry's ability to underwrite political overseas investment insurance risk. Lloyd's has already

established a representative office in the country, and other re-insurers are actively studying the market. These developments will be reinforced if the Government raises the foreign equity cap in insurance companies from 26% to 49%, as it is currently considering.

## Footnotes

1. *Associated Chambers of Commerce and Industry (ASSOCHAM), New Delhi, Study on FDI Outflow and Role of Manufacturing in the Merger and Acquisitions Front, March 2007.*
2. *Since India was historically short on foreign exchange, Indian companies had to seek governmental approve to invest more than a prescribed limit overseas. This limit (US\$2 million in 1992) was US\$100 million by 2002. In 2004, this limit was scrapped: Indian companies can now invest 100% of their net worth overseas without the need to seek governmental clearance.*
3. *An increase from US\$175 million in earlier years.*