Political risk and international business

by Steven E. Hendrix*

Business executives sometimes say that overseas transactions are simply more complex versions of domestic operations. One element that makes these transactions more complex, however, is the increased presence of "political risk." This article explores (1) what constitutes political risk, (2) how exporters can avoid political risk, and (3) what legal problems generally arise with the documentation of political risk insurance.

Political risks defined

Political risk, sometimes called "sovereign risk," has several elements. First, it is found whenever a government prevents a private sector debtor from repaying its obligations. Second, it occurs when the foreign government is itself a debtor and defaults on its own obligations due to its own volition. Third, political risk is present when a government repossesses the assets of a private entity (sometimes referred to as "confiscation," or "expropriation"). Other examples of political risks include imposition of new controls (such as trade restrictions, exchange limitations or monetary controls), and war, revolution or insurrection. Ultimately, the exact definition of "political risk" will be listed in any insurance or guarantee documentation.

Interestingly, political risk is not limited to foreign countries. For example, the United States froze Iranian financial assets during the hostage crisis in Iran. This may have been considered a confiscation by the U.S. Government of Iranian assets. However, despite domestic political risk threats such as this, most businesses are much more concerned about political risks initiated by foreign governments.

In theory, whenever a business suffers a loss due to the occurrence of a political risk, it can receive compensation from that foreign government. However, most countries have adopted the idea of "sovereign immunity." This doctrine asserts that a government is not liable for its actions in court either in that nation or abroad, unless the government submits voluntarily to any such lawsuit. It is easy to understand why not many business executives are eager to discover the limits of this legal doctrine. Therefore, most companies prefer to avoid political risks when possible by insuring against that class of risk.

Insuring against political risks

There are several methods for avoiding political risks, depending on what type of transaction is involved.

Investments: The Overseas Private Investment Corporation (OPIC), a U.S. Government agency, provides political risk insurance and loan guarantee programs to facilitate U.S. private investment in some less-developed nations. To qualify for OPIC insurance, investors must meet certain eligibility requirements. Interested investors should contact OPIC's offices in Washington to apply for its programs.

Foreign sales: The Foreign Credit Insurance Association (FCIA) offers political risk insurance policies to protect exporters from foreign government intervention in selling their products/services abroad. Typically, FCIA coverage is short-term in nature, usually 180 days or less, occasionally up to one year. The FCIA "New to Export," "Umbrella," "Short-Term Single Buyer," "Medium-Term Single Buyer," "Financial Institution Buyer Credit" and FCIA "Lease" insurance policies offer 100% political risks protection, as well as 90% or more commercial risks coverage. FCIA "Bank Letter of Credit" insurance policies are available to approved commercial banking institutions in the United States to insure against both political and commercial risks. Coverage under the Letter of Credit policy is 100% protection with sovereign banks, 98% for

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bulk agricultural sales, and 95% for all other banks and sales.

The FCIA Multi-Buyer Insurance Policy offers two coverage options. First, 100% coverage for political risks is available, but only if commercial risk is limited to 90% coverage and a deductible is included for commercial risks. The second option provides for up to 95% cover for commercial risks, but limits political risks coverage to a maximum of 95%. Past 180 days, however, both commercial and political risks drop to 90%. AIG, a New York private insurance company, also offers similar short-term coverage against political risks.

For medium- and long-term coverage, exporters should consider the Export-Import Bank of the United States (Eximbank), another U.S. government agency. Eximbank offers a guarantee of repayment on 85% of the value of an export transaction, either in U.S. dollars or in readily convertible foreign currencies. After a downpayment of 15%, medium-term (implying a loan of $10 million or less and repayment terms of one to seven years) coverage would guard against 100% of the political risk and 98% of the commercial risk. For long-term obligations (defined as having a loan amount of greater than $10 million or a repayment term of greater than seven years), the Eximbank guarantee may extend to 100% of both political and commercial risks, after a 15% cash downpayment.

Eximbank also offers a "Political Risks Only" guarantee, covering only political risks of nonpayment of principal in transactions with private or nonsovereign public buyers. A nonsovereign public buyer is a government-owned or controlled entity which does not carry the "full faith and credit" of the controlling government. Thus its obligations are not fully backed by the guarantee of a sovereign public entity. In cases where the U.S. exporter is related to the foreign purchaser, this may be the only type of guarantee Eximbank is willing to offer.

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No matter what type of Eximbank guarantee is sought, coverage of interest charged on the loan is not covered 100% automatically. Normally, Eximbank covers interest on fixed-rate loans at the lesser of the rate on the note, minus 50 basis points (1/2%), or the Treasury rate at the time of the loan plus 50 basis points. For floating rates, Eximbank uses a similar formula to decide coverage.

Legal problems associated with political risk coverage

Debate concerning the coverage of political risk insurance generally occurs in two areas : (1) exchange availability versus devaluation in currency, and (2) the issue of causation.

Exchange availability: The one political risk that businesses most often confront is that of foreign exchange availability, sometimes referred to as "transfer risk." Transfer risk occurs when the appropriate government authority fails to transfer (or allow the transfer of) a buyer's qualifying local currency deposit into U.S. dollars. Under Eximbank guarantees, any default due to the failure of the **buyer** to make the local currency deposit within 90 days of the due date is considered a commercial risk -- not a political risk.

Causation: Whenever a government does not directly intervene in the operations of a single business, but, for example, drafts new regulations broadly, to affect an entire industry, it becomes more problematic to declare that an insured political risk has occurred. For instance, a new tax on newsprint levied against all newspapers in the country is probably not government intervention in one particular business. But, if there were only one newspaper in the country, the new regulation would begin to look a lot like direct interference in that company.

As an additional example, it is likely to be argued in the coming months that the U.S. Government, via its policies in the Middle East, "caused" many Iraqi businesses to lose their access to credit. Indeed the purpose of the U.S. policy was to cut off funds to Iraq for political reasons. Thus, it will be argued that the non-payment of debts owed by private entities in Iraq was a foreseeable consequence of the U.S. Government's policy in the region. Of course the U.S. Government's response will likely be that it did not directly prevent any single entity from repaying its debt. In the end, though, for this event or any event to be considered an occurrence of an insured political risk, the policyholder has to show that the government's action constituted a covered political risk, and that this event caused the loss in question.

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you--baggage handling, ground transportation, local multi-lingual guides, changes in air carrier routing, classification upgrades, etc. Non-business group dinners and outings which try to capture the true cultural flavor of the country are also within the scope of the travel assistants. The 1990 Asian mission had a number of first-time Pacific Rim travelers, all of whom expressed their appreciation at having someone available to worry about the details. Group dinners at Happoen in Tokyo, an authentic Mongolian barbecue, a guided tour of Snake Alley in Taipei, and a dinner cruise on Singapore Harbor can certainly contribute to the enjoyment of any business trip.

- **Proximity**

Although the telefax machine has become one of the most important pieces of equipment in any international business operation, there still is nothing like being there. One of my calls was corrective in nature. Being able to sit across a table and present my concerns and receive real-time responses from my counterpart is more valuable than 50 fax transmissions.

Picture the scenario of walking into a group appointment at The Singapore Manufacturers' Association, an organization similar to Wisconsin Manufacturers and Commerce. In the hall were perhaps 100 Singaporeans. We took the group to be a number of interested on-lookers of our meeting. However, they were all buyers! All had been given advance word of our visit, our products and services, and all had "shopping lists." We were literally inundated with Singaporeans looking to buy our products or talk about investment possibilities. When we broke into groups, I had six individuals waiting to talk to me about distribution of my product lines in Singapore and neighboring areas. Of course, you would be able to set something like that up on you own from thousands of miles away.....wouldn't you??

Enough said. As a small Wisconsin business we have benefited from our participation in the trade mission program. Working with the Governor and DOD staff had been a real pleasure for us in every facet. Is participation cost effective? I believe so. In the two Asian missions we have accompanied, both have yielded long-term sales far in excess of the actual costs of the trips. I strongly suggest that when the next brochure comes along announcing a state-sponsored trade and investment mission, give it more than the obligatory 10 second glance before it sails into the wastebasket. Small business or large, the opportunities are available, and the Department of Development may be just the vehicle to get you there--to Snake Alley and back again, that is.

The next Wisconsin Trade and Investment Mission to be led by Governor Tommy G. Thompson will be to Toronto and Montreal, Canada, September 8-12, 1991. Details are available from the Department of Development at telephone (608) 266-1480 or telefax (608) 266-5551.

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With a stable democratic government, a well-educated population, and a well-developed infrastructure of communications, electricity, and transportation, Costa Rica also offers one of the best investment climates in the Caribbean basin. The Government of Costa Rica maintains a positive attitude toward foreign investment, and is especially interested in agroindustry and specialty agriculture. Food processing, light assembly operations, and other labor intensive activities also offer attractive investment opportunities. There are no legal profit or repatriation restrictions or joint venture regulations that could present barriers to direct foreign investment in Costa Rica.

For further information about exporting to Costa Rica, contact:

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