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GUIDE 2024

POLITICAL RISK

Preparing for Threats, Seizing the Opportunities

Perfecting Governance

IN ASSOCIATION WITH:

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Acknowledgements

Francis Kean joined McGill and Partners in 2020 bringing with him thirty years of experience in the industry. Francis is a Partner within the Financial Lines team. Previously, he was a partner at the law firm Barlow Lyde and Gilbert. Francis has handled a wide variety of financial lines claims for both insurers and clients, and has considerable experience of drafting policies and advising all parties in connection with coverage issues. He is a frequent author and speaker on liability issues affecting boards.

Simon Low has 38 years of experience as a lead underwriter for specialty lines heading up Political Risk and Credit solutions as well as Crisis Management including Terrorism, Political Violence and Trade Disruption insurances, as well being an expert witness, and consultant to the World Bank.

Simon Clayton has 28 years of experience in broking property, political and credit risks and bank led surety. Structuring and placement of stand-alone policies and complex programmes. Specialisation has included the arrangement of cover for the commodities, infrastructure, energy and extractives sectors.

McGill and Partners is a global boutique specialist insurance broker focused on large clients and/or those with complex and/or challenging needs. Launched in 2019, the firm has significant backing from funds affiliated with Warburg Pincus, a leading global private equity firm. McGill and Partners is headquartered in London with offices in Bermuda, the US, Ireland, Australia, Switzerland, and Germany.

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About Airmic

Airmic is the leading UK and Ireland association for everyone who has a responsibility for risk management and insurance in their organisation, and has over 450 corporate members and more than 1,900 individual members. Individual members are from all sectors and include company secretaries, finance directors, and internal auditors, as well as risk and insurance professionals. Airmic supports members through learning and research; a diverse programme of events; developing and encouraging good practice; and lobbying on subjects that directly affect our members and their professions. Above all, we provide a platform for professionals to stay in touch, to communicate with each other, and to share ideas and information.

Airmic Research and Technical

Julia Graham, CEO
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Introduction

The Global Risks Report issued by the World Economic Forum has highlighted the "rise of 'ungoverned countries', where non-state actors fight for control over large swathes of territory, or where parties not recognised by the international system gain full control" combined with the risk that "resource-rich countries could become caught in a battleground of proxy warfare between multiple powers, including neighbouring economies, organized crime networks and paramilitary groups". [1] According to the same report, the global economic impact of violence increased to $19.1 trillion in 2023, representing 13.5% of global GDP. By contrast, expenditure on peace building and peacekeeping amounted to $49.6 billion, a mere 0.6% of total military spending over the same period.

In addition to hot conflicts, the possibility exists that so-called frozen conflicts – including in the Western Balkans, Libya, Syria, Kashmir, Guyana, the Kurdish region, the Korean peninsula and Taiwan – could ignite, fuelled by increased resource stress, economic hardship and weakened state capacity, as well as the current political environment. Experience suggests that perils associated with political risk can flare up very quickly in countries perceived to be relatively benign and stable.

More broadly, the rules-based international order – as created through multilateral organisations where the US has led through a significant role – is increasingly being challenged, with alternative spheres of influence now led by China, Russia and the EU. This has resulted in a state of uncertainty for world trade and finance, as previous conventions and rules are being amended, reflecting how the new order influences these transactions. Also, the rise of populist politics around the world further poses a threat to the future of democracy and controlled jurisdictions as the new rules are implemented.

Conflicts contribute to geopolitical risk and have a direct impact on the global economy and international trade. When they are combined with recent pressure on liquidity driven by inflation, limited lending and increased interest rates, the result is that many organisations struggle to effectively manage cash flow and compete across the global marketplace. Inflation may have fallen from the highs of 2022, but inflation in services remains 'sticky' because of tight labour markets and high wages. And while the US Federal Reserve and the Bank of England have begun to cut interest rates, the next reviews still recognise the expectations that we are now operating in a higher-for-longer interest rate environment, which is anticipated to last over the medium term.

Current expectations are that the world economy will be reconfigured in 2025-28 following the 'year of elections'. There is also concern about the impact on trade of:

- the large number of inter-state conflicts
- the interference from governments through sanctions
- widening tariffs
- the cancellation of trade licences
- expropriatory actions.

The forecast for global GDP as a result of these factors is a drop from previous growth levels over the next five years, pointing to a harder trading environment.

Yet, it is not simply conflicts and their effect on the economy which contribute to the geopolitical risk environment which businesses must navigate. A

[1] World Economic Forum: Global Risks Report 2024. www.weforum.org/publications/global-risks-report-2024/

combination of underlying political tensions in various regions is leading to a more destabilised global order, marked by conflicting narratives that are eroding trust and increasing insecurity in societies that have already been politically weakened and economically constrained in recent years.

So, how can directors reliably assess both the short and long-term impact and consequences of so varied and amorphous a set of issues on their businesses? What balance should be struck between seeking opportunities and preparing for threats? To what extent can insurance mitigate the cash flow risks, the major liability risks faced by organisations involved in international trade, and the potential for personal liability exposure to the directors themselves, and protect assets on and off the balance sheet?

The subject is complex and multifaceted. Factors to consider (in addition to the challenge of identifying the relevant geographical spread for each organisation) include:

- Political stability, at regional, national and state level
- Regulatory environment
- Government relations
- Economic conditions
- Corruption and bribery
- Geopolitical events, including regional and global
- Social and cultural factors.

The aim of this guide is to provide a toolkit to assist directors in understanding and keeping pace with this fast-changing and increasingly complex context. It takes the form of 12 questions designed to break a diverse set of issues down into a manageable series of topics. The list is not exhaustive and answers to each question will vary tremendously depending on the size, maturity and nature of an organisation's operations. Nevertheless, in response to each question, we identify a range of issues which are likely to be relevant.

> "Political risk perhaps fits equally well into Donald Rumsfeld's 'known unknown' and 'unknown unknown' categories of risk and is therefore especially difficult to plan for. Nevertheless, there are systems and measures which, if adopted and maintained by organisations and appropriately supervised by boards can help build resilience. If this guide assists in that process, it will have fulfilled its purpose."
>
> *Francis Kean – Partner, Financial Lines, McGill and Partners*

> "Geopolitical risk is becoming far higher in profile on the risk radars of most businesses and is a board agenda item. Businesses are constantly monitoring and navigating the short-term risk outlook, scanning the horizon and analysing scenarios for the longer-term view, but keeping an eye on the innovations and strategic opportunities that can emerge from volatility."
>
> *Julia Graham, CEO, Airmic*

1 What are some of the main political risks which might affect the organisation?

Characterised by instability and change, political risks are inherently difficult to anticipate and prepare for. They may range from the disparate effects of conflict and unrest to sudden government or regime change in the country in which the organisation is doing business – this will likely also affect other countries as well as the organisation's competitors, through contagion effect. They may also take the form of targeted unilateral decisions by state-owned entities to terminate contracts in retaliation for unrelated decisions taken by the government of the country in which the organisation is headquartered.

In our increasingly interconnected world, geopolitical events can exacerbate existing business-critical risks as they relate to energy security and the supply of critical minerals, for instance. Climate risk can also have wide-ranging impacts on national security and global stability, such as when severe weather events disrupt supply chains, leading to economic instability.

2 By which criteria should I be identifying, assessing, mapping and keeping under review the geographical and territorial scope of the organisation's exposures and the impact of these on the stakeholders and supply chains, with which I should be concerned?

Given the complexity of this topic for any organisation with international operations, your responsibilities as a director are likely to focus on obtaining appropriate assurances as to the robustness of the measures taken by the organisation's management to identify and mitigate political risk. Here are some useful questions to ask:

- How does the organisation conduct risk assessments of the political landscape for the regions and jurisdictions where the organisation operates or plans to operate, including as to political system governance, stability and potential for civil unrest?
- Is regular horizon scanning and scenario analysis conducted for emerging political risk and impact on business operations?
- What controls and associated actions has the organisation established to manage the risks identified? How are these allocated and reviewed? Do controls include steps to diversify investment and/or supply chains to spread the risk and reduce reliance on any single market, product or supplier?
- Is there a strong network of local relationships with government officials, regulators, communities and other stakeholders in key jurisdictions aimed at fostering goodwill to provide a potential buffer against political risk?
- Do crisis management plans exist for countries in unstable political regions to ensure the safety of employees and the organisation's assets?

> "Given the instantaneous news cycle we live in, it is easy for organisations to be carried away by the headlines. But there is a risk of 'fighting the last war' – by wrongly applying the lesson of the last geopolitical crisis to the next one. There is also a tendency of treating political risk as a game of predicting the future, but geopolitics almost never goes to script. Rather, horizon scanning and scenario planning are the keys for organisations to manage political flux."
>
> *Hoe-Yeong Loke, Head of Research, Airmic*

3 How does legal/regulatory risk relate to political risk?

The point at which a 'standard' legal or regulatory risk may become tinged with political risk can be difficult to identify. This can occur where law or regulation is deployed in a selective or discriminatory manner. To some extent, an organisation can mitigate this risk by ensuring that its significant and material contracts are not subject to local jurisdiction and/or choice of law in countries perceived to be high risk. Of course, that may not always be a commercially acceptable outcome for the trading partner or government authority concerned. In such cases, understanding local law and ensuring compliance is obviously desirable. It may also be appropriate specifically to address political risk through force majeure clauses and to further mitigate such risks through insurance (see answer to question 10).

Elections in which governments change (more or less democratically) are a key driver and trigger for legal and regulatory risk. Organisations should invest in monitoring politics and elections in the key markets in which they operate.

> "There are big strategic questions as the world becomes increasingly divided. For instance, does a globalisation strategy still make sense? And these are very difficult questions to deal with using traditional frameworks. This calls for risk, internal audit and strategy to work a lot closer together."
>
> *Political Analyst*

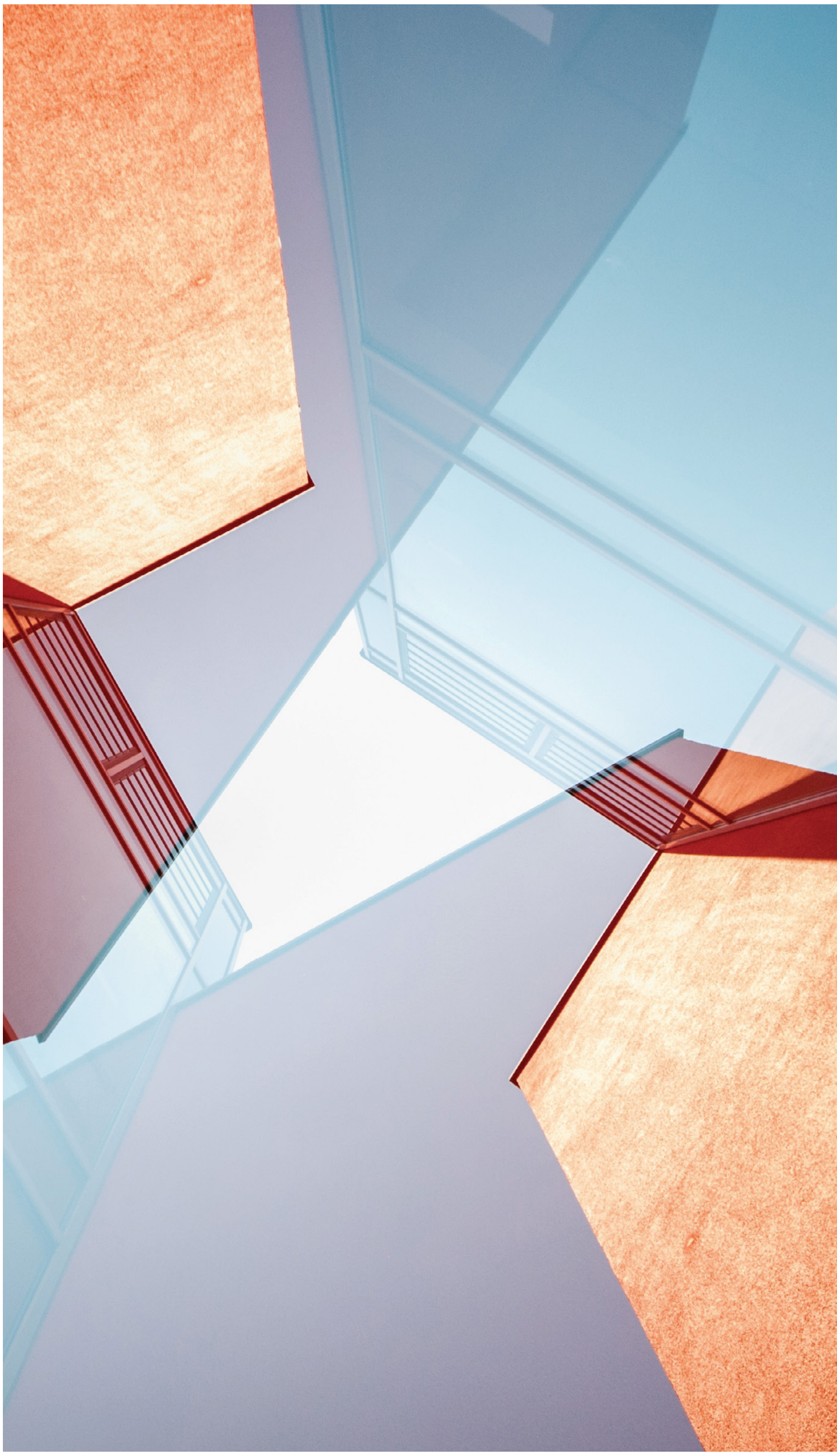
4 Which stakeholders within the organisation need to be connected with and focused on assessing and tracking the relevant risks?

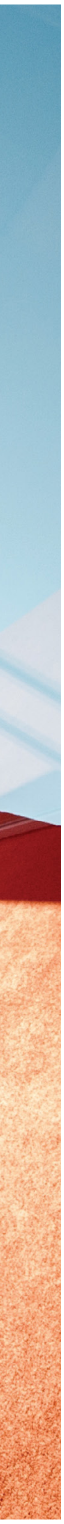
The size and nature of the identified risks will vary considerably from organisation to organisation, as will the management structures configured to address them. Other stakeholders within an organisation who should arguably be engaged and aligned to the extent desirable include the risk management, corporate strategy and business development, legal and compliance, finance and treasury, human resources, operations and supply chain, international business, IT and data security, and corporate social responsibility teams, and external advisers and consultants as required. Depending on the size of the organisation, gaining appropriate assurance at board level that this potentially disparate group of stakeholders is working effectively together can be a challenge.

The Three Lines governance model provides a useful framework for building and implementing robust assurance across an organisation, including providing transparency over the effectiveness of the governance, risk management, and internal audit and control processes as they relate to political risk.

5 What (if any) internal guidance statements are scoped with other resources to set and monitor existing political risk tolerance?

For larger organisations, internal guidance and statements regarding political risk tolerance and appetite are important for establishing a clear framework for decision-making and risk management. A political risk framework may be desirable under which guidelines covering matters such as political stability, regulatory environment and the potential for civil unrest are set out. This might be combined with a system for categorising such risks (e.g., low, medium and high) to facilitate informed decision-making and prioritisation of risks. Depending on the type of governance structure operated by the organisation, responsibility for oversight may be delegated by the board to the risk management committee or the audit committee. Other relevant frameworks and guidelines might include stakeholder engagement policies, investment decision guidelines, and ethics and compliance statements.





6 Where does ultimate responsibility both for strategic decisions and day-to-day management decisions with a significant political risk element reside?

The ultimate legal responsibility for supervision of political risk (as with all other significant issues affecting the organisation) resides with the board and cannot be delegated. In practice, the board – sometimes at the recommendation of a committee of the board – should set the strategy and approve the organisation's risk appetite and tolerance levels as well as its overall political risk management framework. Depending on the nature and size of the organisation's operations, day-to-day management decisions would typically be handled by a combination of regional and local managers supported by various departments and committees, including some of those listed in answer to question 4 above.

> "Risk professionals must have regular, open, and informed communication with the board on political risk. Political events can have a significant impact on the ability of a business to achieve its strategic objectives. Risk professionals must consequently understand political risk and have the information, tools, and techniques available to enable them to do so. This will empower them to speak up about how political risk might impact the business and the options available to assess and respond to this risk."
>
> *Julia Graham, CEO, Airmic*

7 Are there upside risks to geopolitics?

As with any risks, political risk can have an upside as well as a downside. There are opportunities that organisations can tap into if they are agile and aware of the geopolitical environment in which they operate.

For example, the government of a relatively closed economy could change its stance to welcome foreign direct investment in specific industries over time. Businesses which are attuned to such shifts in politics and make plans to invest could enjoy first mover advantage.

8 What types of events and catastrophic claims have occurred, and which industries have been affected?

A number of global events have occurred, including the Banking Crisis in 2007-09, which have had a far-reaching impact across industries with a large number of credit claims, as well as more specific events such as coup d'états and economic crises affecting individual countries, which have led to confiscation, licence cancellation and property damage from political violence.

More recently, we have seen a large impact on the Political Risk / Credit Risk insurance markets from Russia's invasion of Ukraine, leading to direct losses emanating from both countries but also to delays and losses impacted by sanctions and supply chain interruptions to many other countries. We have seen how the war has led to significant disruption to global wheat markets. Hundreds of aircraft from Western leasing firms have been stranded in Russia.

Houthi rebel attacks on ships passing through the Red Sea have led to their being rerouted, which has disrupted global supply chains and incurred higher freight costs.

Supplies of raw materials have also been interrupted, leading to increased costs and production delays affecting developing countries reliant on a smooth-running international trade infrastructure system. (See also the Airmic-McGill and Partners guide on *Supply chains – Keeping up with the pace: Perfecting Governance.*)

9 What is force majeure in a political risk context?

Force majeure means 'greater force' and is related to an act of God, an event for which no party can be held accountable. Force majeure clauses are typically employed in contracts to cover events for which it is accepted that no party can be held accountable provided that the events in question are sufficiently extreme and unforeseeable. Examples include acts of nature such as earthquakes and storms, but they can also apply in a political risk context to war, coup d'etats and certain government actions deemed to be outside of international law, such as the appropriation of assets without cause. To that extent, they may be insurable (see answer to question 10 below).

10 How do Political Risk insurance and Credit Risk insurance help mitigate risk, and what scope and limits of cover are typically available?

Political Risk insurance provides protection for assets held on the balance sheet both from catastrophic events and from property damage as a result of political violence, as well as for the attendant business interruption loss. Credit Risk insurance covers the risk of default within international trade contracts. It can be triggered when a counterparty defaults on its payment obligations either due to force majeure or for any other reasons, preventing the performance of a legally binding contract.

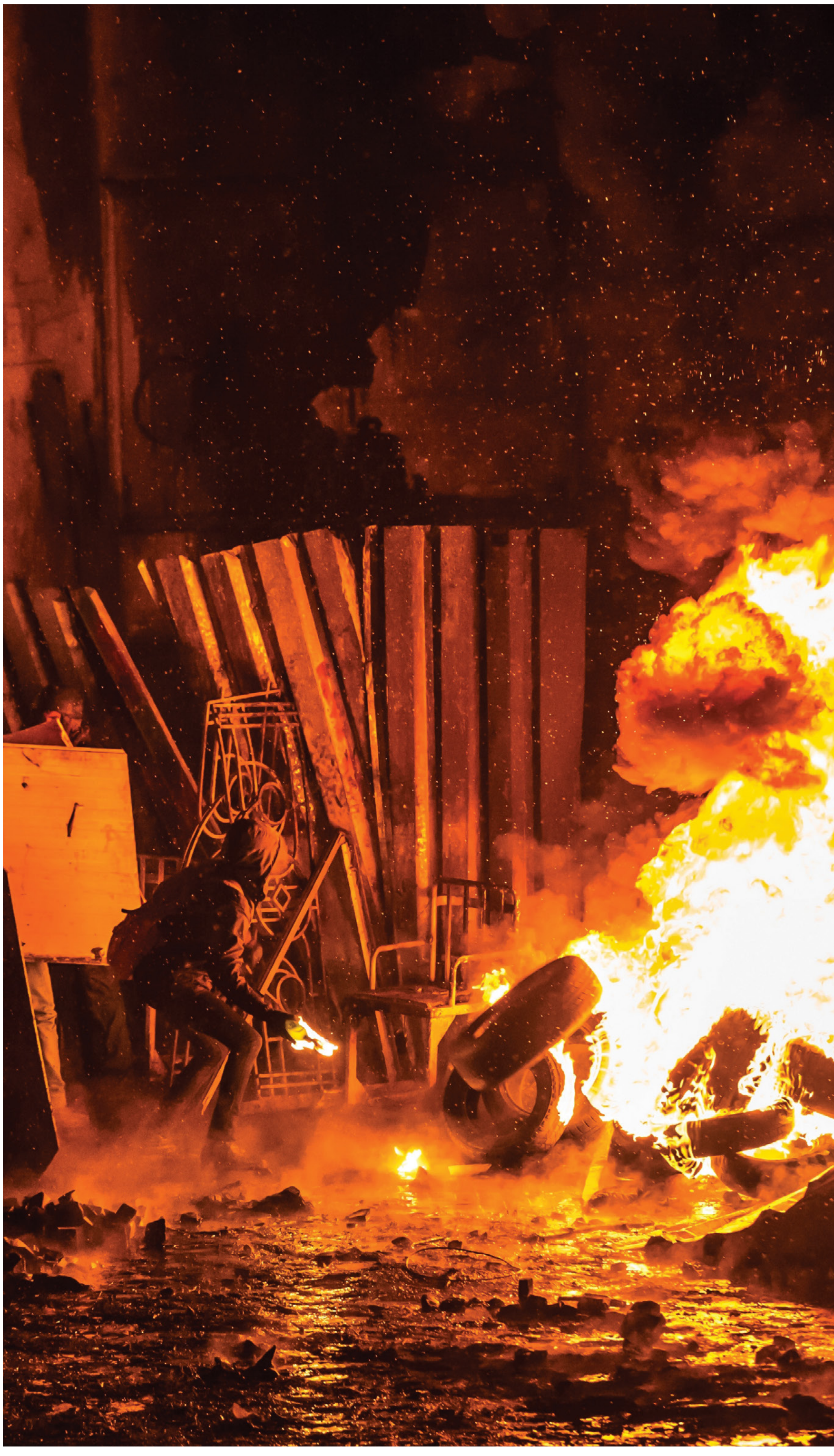
Having assessed the risk appetite and need for cover, typical limits for Political Risk insurance protecting assets from expropriation and associated perils would be £400 million, though theoretical market capacity would suggest over £2 billion is available for a specific risk.

Credit Risk insurance limits are more typically £50 million any one contract/obligor, although again theoretical limits available from the market would be up to £1.5 billion.

11 What other classes of insurance may be relevant?

Both Political Risk and Credit Risk insurance are often considered alongside other crisis management lines of business which enhance not simply the protection of the organisation's assets and its cash flows but also its employees. Examples include personal accident and evacuation in the event of a political crisis and kidnap and ransom. Bespoke cover can be provided for property against war and terrorism as well as for product recall linked to crisis management. The Political Risk market can also provide coverage, designed on a 'difference in conditions' or back-to back basis, to plug the gaps left by exclusions within the more mainstream insurance classes.

Finally, Directors and Officers liability insurance may operate as a backstop form of protection for directors in the event of liability claims emanating from political risk scenarios (see the Airmic-McGill and Partners guide on *Directors & Officers liability insurance: Perfecting Governance*).



12 How should sanctions risk be addressed?

Sanctions are imposed by governments to achieve specific foreign policy and national security objectives. A breach of sanctions – especially those imposed by the UK and the US – is often a serious criminal offence. If an organisation does not respond to sanctions in a timely and effective manner, there will be a negative financial, reputational and regulatory impact on it.

Organisations need to conduct a sanctions risk assessment that is tailored to their profile, and that should be kept up to date and reviewed regularly. They should also evaluate the exposure of their whole business to sanctions risk. Separately, a client risk assessment should also be conducted, which will inform the organisation's sanctions risk assessment.

The key sanctions list to consult is the one maintained by the Office of Foreign Assets Control (OFAC) of the US, while the guidance on sanctions covered by the UK's Office of Financial Sanctions Implementation (OFSI) and the Office for Trade Sanctions Implementation (OTSI), and the United Nations Security Council Consolidated List is also important.

As for the question on the impact of sanctions on the availability of insurance, coverage is generally available for the vast majority of countries, with exceptions being those with strict sanctions as determined by the UK, EU, US and UN bodies (see above) such as Iran, North Korea and Russia. Insurers will typically include sanctions exclusions across all classes of insurance but these merit scrutiny as the scope and breadth of them may vary.

> "The temperature of the geopolitical climate continues to heat up. In this context, no organisation can afford to mis-step in relation to managing sanctions.
>
> "As sanctions regimes evolve, proactive monitoring of business activities, screening of sanctioned parties, scanning the horizon and creating relevant triggers for action, training at all levels, and the constant review of other control measures are key to avoiding a sanctions breach – and if one should occur, being clear on what to do."
>
> *Justine Cowling, General Counsel, BCLP*

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