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Scoping out the solutions

Almost half of Africa's countries are considered high risk for political violence. Dr Barbara Samuels looks at the impact of terrorism on African investment and the emerging solutions

Africa is the global pinnacle of investment needs and opportunities today. Economic growth rates and numerous expert studies provide indisputable evidence of Africa's potential for continued high economic growth, meaningful profits, and new markets.

However, the confluence of opportunity and challenge is daunting: only one quarter of African households today has access to electricity, and even those customers often experience power shortages. Africa's massive potential consumer market is set to greatly increase as its population doubles to an expected 2.4 billion by 2040. Moreover, Africa's natural resources are of strategic importance to global powers. China's resolute quest for investment and trade throughout the continent and the Obama-led US-Africa Leaders' Summit in August 2014, accompanied by the US Power Africa Initiative, exemplify how Africa has become a high priority for investors and governments worldwide.

At the nexus of global economic relations with Africa is the spectre of a growing incidence of terrorism, coupled with outbursts of violent activity. Many experts on Africa foresee a continued uptick in volatility concurrent with spectacular economic growth, driven by accompanying economic, social, cultural, and religious dislocations, including increasing economic inequities, endemic corruption, and criminal activity.

What are the risks arising from these unwelcome developments and how can Africa still realise its huge economic potential? What are the instruments and strategies available to governments and investors to protect themselves from terrorism and maintain the resiliency needed for continuous growth and improved living standards?

Terrorism in Africa today

The nature of terrorism in Africa is wide-ranging. The risk of less costly but escalating terrorism attacks in the more stable countries, combined with fragile states where terrorism is pervasive and entrenched, limits investment and economic growth. As AIG Senior Insurance Executive John Hegeman explains, “When underwriting terrorism risk, we assess the probability of terrorism events and the likely size of any losses. A grenade attack in Nairobi is more likely than in New York City, but the economic loss is likely to be larger in New York City.”

In fact, a review of terrorism attacks in Africa reveals that the size of reported losses is relatively small to date. In most cases, the reported losses from terrorism attacks are focused primarily on personal victims, with the tragic loss of life and kidnapping limited mostly to African people, not international investors. Nor has there been extensive loss of property, with the exception of Nairobi’s Westgate Mall attack, the US embassy attacks in East Africa, and the Amena gas plant attack in Algeria.

The payout experience of the insurance industry reflects this fact. For example, the loss of life and property loss in the World Trade Centre attack was much greater than all the Kenya terrorism incidences together over the last few years (notably the post-election violence, followed by the attacks claimed by Harakat al-Shabaab al-Moujahideen at the Westgate Mall attack and the recent June 15 killing of at least 48 villagers in the Kenyan town of Mpeketoni).

Therefore, while Africa bears the burden of the highest risk ratings for terrorism (see Aon’s risk map), the type of terrorism and its immediate impact on existing investment is widely considered by insurance experts to have a much lower magnitude of potential loss than that resulting from full-blown catastrophic terrorism attacks in developed countries.

Availability

Fuelled by the 9/11 New York City terrorism attack, the supply of terrorism and related political risk insurance has increased exponentially worldwide, resulting in the development of the terrorism specialty “T2” market in London and global excess capacity of terrorism risk insurance. In fact, some industry experts indicate that terrorism risk insurance prices are at their lowest levels to date. Moreover, additional capacity from new entrants in political risk insurance is expected to result in softening pressure on premium rates.

Both private and public sector insurers and their brokers claim they are open for business for terrorism and other political risk insurance throughout most of Africa, with private sector insurers (Munich Re, Hannover Re, Swiss Re, Berkshire Hathaway/General Re) and public sector insurers (export credit agencies and MIGA) offering a critical supply of reinsurance. For example, OPIC’s Director of Insurance John Moran notes the availability of cover even in the higher risk countries, such as the Democratic Republic of Congo.

Demand

On the demand side, a 2013 report by the World Bank’s Multilateral Investment Guarantee Agency (MIGA) states that terrorism and political risk insurance worldwide is increasing at a level of approximately 33% annually (albeit from a low base); a higher rate than the annual rate of FDI investment. The key reported drivers of demand include general market turbulence, including the still-unfolding Arab Spring, the Ukraine-Russia conflict, high-profile expropriations, persistent resource nationalism, capital constraints, and regulation.

While insurers report a sustained increase in demand for terrorism cover, especially in Africa, investors are not specifically citing terrorism as their main concern. In the 2013 survey commissioned by MIGA, “adverse regulatory changes” tops the list of political risk concerns for investors in developing economies. The risk of terrorism is far behind at 13%, with the more broadly defined “civil disturbance” coming in at 33%. However, in all but a handful of cases, MIGA’s political risk insurance clients in Africa are opting to include cover for war and civil disturbance (WCD). So, while adverse regulatory changes may be at the forefront of investor concerns in Africa, investors also have concerns about WCD.

Further, the absolute amount of contracted political risk insurance policies is small relative to the level of investment (only reaching approximately 15% of FDI in 2012). In fact, the MIGA study reported that much higher percentages of investors in their annual survey use pre-emptive risk mitigation strategies (25%-54%) compared to only 15% of the investors using political risk insurance.

Examples of reported reasons for investors not buying political risk or terrorism insurance include lack of education, knowledge or time; cost or perceptions of cost; lack of availability; ineligibility; and type of investment and duration. There is also insurance substitution: some investors feel they can protect themselves adequately using other methods such as an implementation agreement with the host government, backed up by regular annual insurance policies.

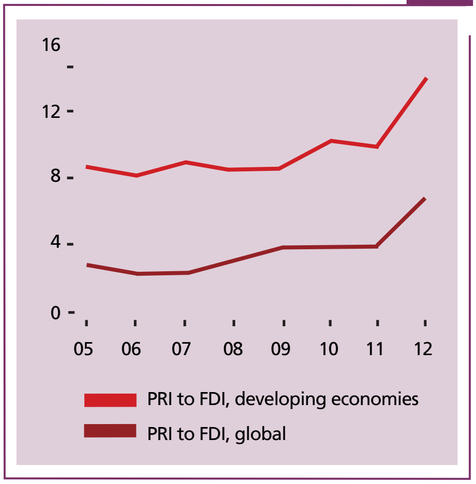
Pre-emptive risk mitigation

Pre-emptive risk mitigation strategies include a range of activities, from engaging local companies, local communities and the host government to scenario planning and political and economic risk analysis.

To illustrate the value of pre-emptive risk mitigation strategies, MIGA recounted the case of a political risk insurance policy they issued in Nepal, where the investor led a robust social development programme that reduced the impact of a terrorist attack. In October 2002, insurgents sabotaged the intake of the Khimti facility in Nepal, as well as a small hydropower plant providing rural electrification to neighbouring villages. The reported damage was small compared to the scale of the investment, given that support from the local community prevented escalation and further incidents. MIGA points out that the engagement of the local community constitutes in effect a “license to operate.”

In fact, MIGA’s Policy on Environmental and Social Sustainability requires MIGA to ascertain whether a proposed investment

Ratio of PRI to FDI flows: global versus developing economies (%)



Source: Berne Union Secretariat and World Bank, World Investment and Political Risk Report, MIGA has "Broad Community Support."

MIGA explains that this is essentially "a collection of expressions by affected communities, through individuals or their recognised representatives, in support of the proposed business activity. Investors increasingly realise that implementing best practice in environmental and social standards – including community development programmes – can make or break an investment. In the case of terrorism, this could potentially spare an investor's facility from attack or mobilise a local community to put its limited resources into protecting the facility."

Importance of insurance and new applications

While local terrorism and political risk can be reduced significantly by such pre-emptive strategies, the overall risk of terrorist attacks is not eliminated given the inherently unpredictable nature of terrorism and the innumerable sources of perpetrators. In fact, given the escalating incidents of terrorism throughout Africa, some experts claim that terrorism and related violence represent significant widespread risks to businesses and local communities and threaten the continent at large.

Moreover, the US Managing Director of Clements Worldwide, Dante Disparte, claims that Africa is critical to the future of companies worldwide: "Africa represents the next 100 years of global growth. Terrorism is unpredictable. The companies that change their corporate culture and become adopters of 'survivalship' will be the ones that prevail," he says.

To illustrate further, Conal Duffy of Alliant reported that the recent political unrest in Thailand is allegedly costing the country's economy several billions of dollars, most of which was not insured for business interruption. As a result, foreign investment has essentially dried up, with spill-over effects in the larger economy. Duffy also explains that growing sectors in Africa, such as agribusiness, face the risk of local terrorism and violence.

"We have had US investors in crop processing facilities get the investment go-ahead from presidents who then back-track once international non-governmental organisations rally together with local communities against such investments," Duffy says. Whole sectors require the careful structuring of risk mitigation strategies, both pre-emptive activities and insurance, to reduce the exposure of investors, economies, and the population at large to systemic risk.

"We see many investors failing to develop clear risk management strategies and that being a key reason for not investing in Africa"

Innovation in terrorism and political risk insurance is being driven to meet the needs of investors, both in terms of new risk coverage and local industry mechanisms to reduce pricing. In terms of expanded insurance policies, examples include: coverage for senior secured project finance debt (AIG) and private equity funds (OPIC), event insurance (Beazley), flight insurance (Beazley), cyber insurance (Zurich), forced abandonment and political execution (various providers).

According to Souvik Banerjea, Senior Marketing Officer of the Nairobi-based African Trade Insurance Agency (ATI), insurance pools are critical to reducing pricing; for example, rates for terrorism insurance are much lower in South and Southern Africa, where two insurance pools are in existence, SASRIA and NASRIA.

Implications of the insurance demand gap

So what are the implications of investors not using terrorism and political risk insurance? The "insurance demand gap" is cited often: investors want to cut costs as much as possible, even if they recognise the risks. In many cases, while the risks are longer term, investors will buy short-term less expensive insurance, often because they expect to sell their investment positions in the short-term.

Pricing is cited as a key deterrent, especially in local insurance markets, creating a "missing middle." For example, even in Kenya, the uptake of terrorism and sabotage insurance offered by local and international insurance companies is reported to be low. As ATI's Banerjea states: "Following the post-election violence in December 2007 and 2008 in Kenya, the demand for insurance covering terrorism and political violence witnessed a steep upswing. However, the steep cost of such insurance has been a major deterrent in the actual uptake for the product. It was mostly the large industries that took up the insurances, with smaller players expressing interest but shying away at the prices. There was a slight increase in requests for cover by shopping mall owners after the 2013 Westgate attack in Kenya."

This overall lack of demand for terrorism insurance (and more generally political risk insurance) is seen by some investment professionals as a problem decreasing the ability to attract investors to both new and existing projects and companies in Africa.

As Clements Worldwide's Disparte states, "We see many investors failing to develop clear risk management strategies and that being a key reason for not investing in Africa. Investors need to develop risk management strategies including the use of insurance at the pre-investment stages. The perception of risk – including terrorism – is reducing investment in Africa by both international and local investors. Investors need to know there are ways to recoup their investment and lost income."

Moreover, given the need to secure finance from institutional investors and sovereign wealth funds, insurance serves as a critical instrument to provide the necessary level of protection and meet due diligence requirements.

Insurance solutions

Market participants speak of the need to advance the use and application of insurance through a wide range of actions: greater knowledge of insurance products and innovative applications; increasing the catalytic role of brokers in identifying and qualifying clients, customising packages to meet client needs and bringing together the different insurers as needed; strengthening host country regulatory frameworks to improve the local insurance market; and the need to scale-up both local insurance pools and captive pools insurance based on sectors.

Insurance solutions depend in large measure on the catalytic role of brokers in applying insurance to investor needs. For example, OPIC Vice President of Insurance John Moran provides the example of an innovative US $350 million political risk insurance facility facilitated by a broker to protect each of the investments made by the Silverlands Fund, a private equity fund focusing on agribusinesses in several countries in sub-Saharan Africa. OPIC will serve as primary provider of the political risk coverage that will protect each of the investments, and MIGA as reinsurer will take on 60% of the risk of each investment.

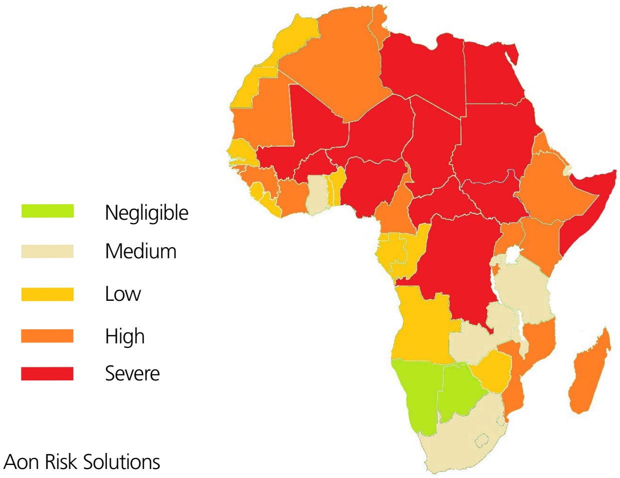
This joint OPIC and MIGA effort is a significant new development in the political risk insurance marketplace, helping to attract capital for private equity investment funds by providing fund managers with an effective instrument to mitigate losses resulting from political violence, expropriation and currency inconvertibility. The Silverlands Fund plans to reach 500,000 small farmers over the next ten years, leading to an estimated increase in total food production of over one million tonnes per year, addressing the needs of both local farmers and global food security. The scaling up of these models depends in large part on engaging brokers who can be innovative and effective in applying insurance across providers.

Another transaction model for scaling up is the $1 billion political risk coverage for Apache Corporation's investment in Egypt, the largest producer of natural gas in the Western Desert, an area vital to the continued growth of the Egyptian economy. Some of Apache's coverage expired in late 2011 and was not renewed, partly because of concerns stemming from the Arab Spring uprisings. In response, OPIC together with Alliant, a US broker of political risk insurance, worked with US private market insurers to encourage them to provide the necessary coverage.

Finally, investment models can limit investment and create systemic sources of risk. Innovative new approaches that go beyond the simple use of discount rates in investment models are needed, that include a more comprehensive identification of risks and implementation of solid risk management strategies, including insurance. As Disparte of Clements Worldwide states, "We need a new playbook where insurance costs are integrated into fixed costs, using run-of-the mill insurance to serve as guardrails covering the full gambit of inherent risks such as the need for medical evacuation and property protection."

Such models could to be scaled up to increase investment in Africa. To advance access to information and solutions, the Global Clearinghouse of Development Finance has developed a global on-line platform serving as a one-stop shop of risk mitigation instruments and techniques (see www.infradev.org).

Terrorism and Political Violence Map 2014 (Africa)



Source: Aon Risk Solutions

Perceptions of African volatility and the limits of insurance

Several senior industry executives express concern, citing the increase of terrorist attacks and overall violence in Africa, and see this as worrisome sign of overall deterioration in the business environment and weaker national governments.

The former President of AIG Political Risk Insurance John Salinger says, "This is not an insurance problem and there is no insurance solution. The fact is that the large capacity for insurance in Africa is not being absorbed, and this is a telling sign. Insurance is not a driver. FDI and local investment is not as strong as they should be. Why is that? The benefits of increased economic growth in Africa need to be shared with the larger population. Growing inequality in Africa is resulting in civil strife and terrorism, creating the seeds for the corruption of Islam with radicalism. If we drill down, it is the lack of rule of law, pervasive corruption, and lack of government accountability limiting investment in Africa – not the lack of insurance for terrorism and other political risks."

What is the optimal strategy for investors – local and international – and host governments to reduce the risk of terrorism and related violence in Africa? For the investor, the ultimate risk mitigation strategy is designing investment projects that are aligned with national and community development goals, adding risk mitigation support as needed.

For national and local governments, the wellbeing of their countries and the ability to mobilise investment depends on installing meaningful tracking systems, complete with operational performance benchmarks that ensure accountability, rule of law and enforcement, public benefits, and reduced corruption. Realising Africa's vast opportunities requires the strategic use of both investment and risk mitigation, employing the full panoply of pre-emptive measures and insurance. Ai

Dr Samuels is the Executive Director of the Global Clearinghouse for Development Finance, a non-profit organisation committed to advancing risk mitigation for private sector mobilisation